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E-BRIEF

November 26, 2012

INTERNATIONAL ECONOMIC POLICY

# Speed Dating or Serious Courtship? Canada and Foreign State-Owned Enterprises

by
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- Two acquisition bids by foreign state-owned enterprises (SOEs) for Canadian resource companies have raised an array of concerns about their potential impact, ranging from worries about national security and governance standards to reciprocal access to markets.

- While Ottawa's current screening rules and guidelines are mostly adequate to address these concerns, mechanisms should be created to more explicitly address possible anti-competitive impacts of SOE investments and to review whether SOEs keep their good governance commitments.

- If Canada wants to benefit from Asia's long-term growth potential, there is no getting around the need to facilitate trade, investment and other exchanges with China – and with other economies where the state currently plays a determining role.

**The proposed acquisitions of Nexen, a medium-sized Canadian oil and gas producer, by CNOOC, majority-owned by the Chinese state, and of Progress Energy by Malaysia's state-owned Petronas, have put Canada's "net benefit" test for large foreign acquisitions of Canadian businesses back in the spotlight. Together, they have raised fresh concerns about the impact of foreign state-owned enterprise (SOE) investment in Canada.[1]**

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The author thanks Philippe Bergevin, Loren Brandt, Don Brean, John Curtis, Ben Dachis, Wendy Dobson, Rick Eckstein, Michael Hart, Larry Herman, Finn Poschmann, Bill Robson, Dan Trefler, and others who wish to remain anonymous, for their perceptive comments on earlier versions of this paper. The ideas, recommendations, and any errors that may remain in the paper are entirely the author's responsibility.

1 Canada's Industry Minister rejected the proposed Petronas acquisition in October 2012. Petronas subsequently submitted a new proposal with further undertakings it hopes will lead the Canadian government to approve the investment.

Critics evoke threats to Canada's national security, unfair competition for Canadian assets, SOE governance practices leading to poor economic outcomes, and lack of reciprocity for Canadian firms in SOE investors' home countries. The implication is that current Canadian screening rules for foreign investment may be inadequate to deal with these concerns.

Under the *Investment Canada Act*, Canada screens large[2] proposed acquisitions to determine whether they are a "net benefit" to Canada. This net benefit test is not amenable to clear explanation, but it often results in detailed operational conditions imposed on Canadian businesses acquired by foreign entities, whether public or private (Bergevin and Schwanen, 2011). Guidelines issued in 2007 illuminate somewhat how the test will be construed for foreign SOEs. The *Act* also provides for additional scrutiny for proposed foreign investments, regardless of size, that could be injurious to national security.

Below, I examine the concerns raised by the proposed acquisitions. While current screening rules and guidelines are mostly adequate to address them, I also propose mechanisms to more explicitly address possible anti-competitive impacts of SOE investments and to review whether SOEs keep their good governance commitments. Further, I propose a formal governmental dialogue to address barriers to Canadian investments in SOE home countries.

## Concern 1: National Security

Almost every country formally or informally screens proposed foreign investments to ensure they do not threaten their national security. The most recent public report by the Canadian Security Intelligence Service notes that investments by firms that do not operate at arm's length from their home country government can be a concern for Canada's national security (CSIS 2012, p.19).

The current Canadian national security test, which provides for consultation with numerous departments and agencies to assess potential threats to national security, appears sufficient to the task of identifying threats to security originating in a particular investment. Canada, however, should do more to clarify what it will construe as threats emanating from foreign investment, as does the US, for example. A distinction needs to be made between foreign investments that enable a foreign power to have access to sensitive intangible assets, such as information, that can be accessed at the flick of a switch, and investments in immoveable assets or in know-how that pose no such threat. Canadians, as the ultimate owner of resources that cannot be moved lock, stock and barrel, and whose extraction and trade typically requires significant government regulatory approval, will continue to have significant control over the fate of companies exploiting those resources, irrespective of who holds the right to exploit them.

## Concern 2: Unfair Competition for Canadian Assets

One concern is that state-owned acquirers benefit from access to cheaper-than-market financing or tax breaks at home, creating an uneven playing field with firms in a target country. Enterprises that do not operate at arm's length from the state often benefit from such support in their home market. Often, in exchange, they must

2 In 2012, proposed acquisitions of Canadian businesses with assets worth $330 million or more triggered a review. The threshold is much lower for acquisitions from non-WTO countries and in cultural industries.

submit to operating constraints such as maintaining certain levels of employment or purchasing from inefficient domestic suppliers.

States like China enjoy a cost of borrowing lower than do many private corporations. Yet Chinese state-owned firms also face opportunity costs like everyone else: while China may harbor some non-economic goals behind some state-owned foreign investments, it also has an incentive to earn a high risk-adjusted return on them. And there is no economic reason why private investors in, and lenders to, CNOOC would accept a rate of return lower than those offered by many possible alternative investments.

Nevertheless, to address concerns about the unlevel playing field between private and foreign state-owned enterprises vying for the same asset, a mechanism could be established through which a potential bidder could lodge a complaint about the perceived unfair subsidization of a rival state-supported bidder. Such complaints would be adjudicated in the same way that complaints regarding unfair subsidization of imports are – namely, a determination would have to be made that there is unfair subsidization and that the complaining party is injured by the subsidy. Naturally, the question would arise as to why Canada would not offer the same recourse to Canadian businesses that similarly face competition from state-owned Canadian enterprises. It should be noted that there are no such rival Canadian bidders publicly lining up to acquire Nexen or Progress.

## Concern 3: Corporate Governance Inimical to Canada's Growth

Another concern is that with cheap, state-backed capital comes inefficient management. But businesses operating inefficiently under state-imposed constraints in their home market will not necessarily run economically inefficient operations, or hire poor managers, when they operate abroad under a different set of rules and incentives. Significant differences in behaviour among different SOEs, and even among subsidiaries of the same SOE, invite a case-by-case rather than blanket approach to evaluating the likely impact of foreign SOE investments.

Unless the Canadian government determines the companies that have agreed to be acquired by CNOOC or Petronas would, as a result, shift their focus away from efficient use of resources, it is hard to see why any such acquisition should be rejected out of hand. Current guidelines already make it plain that the Canadian government will look at factors such as commercial orientation, transparency, or the number of Canadians on the board of the acquired company, and seek undertakings of the foreign investor on these and related matters. Together, these should alleviate concerns about the negative impact of ultimate foreign state ownership on enterprise governance. Canada should also promote the use of the OECD Guidelines on Corporate Governance in state-owned enterprises (OECD 2005) in its relations with non-OECD economies.

Legitimate questions exist about the enforcement of such undertakings, and in general how to address governance and compliance issues that could quickly escalate into state-to-state disagreements. Here, Canada could envisage an up-front agreement on an audit process that would keep the acquisition under regular review, perhaps ultimately backed by some form of arbitration in the event the audit uncovers unmet undertakings. Canada could draw on its competition law, and straightforwardly clarify that related entities controlled by a single foreign state will not be allowed to dominate its oil and gas or other sectors.

## Concern 4: Lack of Reciprocity

The home country governments of companies that have close ties to the state will often impose significant barriers to foreign ownership in their own market. This is the case with China, which has led a number of commentators to demand reciprocal access for Canadian investors there, in exchange for Canada approving major investments by Chinese state-owned firms in Canada.

While reciprocity – understood as a step toward the ideal of free investment flows in open markets – is a worthwhile principle, it would be hard to impose as a condition for accepting any particular proposed transaction. If it tried to do this, the government would, in effect, be using the interests of Canadian owners in one company as a bargaining chip to advance the interests of shareholders in other companies, which would only add to the controversy surrounding the application of the "net benefit" test.

China's illiberal political system will not change overnight, yet it continues its rapid evolution towards a pro-competitive economy. Adding demands for immediate reciprocity to Canada's stated policy regarding foreign direct investment amounts to inviting rejection by China of further mutually beneficial engagement with Canada. Rather, Canada's interest as a significant foreign investor itself is to emphasize the continuing need to build rules-based regimes to which countries large or small agree to adhere for the common economic good.

In this vein, Canada should build on the process recently established between Canadian and Chinese officials to produce the Canada-China Economic Complementarities Study (Canada 2012). A bilateral working group could be tasked with reporting annually and publicly on the openness, performance, opportunities, intellectual property protection, and security implications of bilateral investment and trade. China is now becoming concerned by the push-back that proposed Chinese investments are receiving in a number of countries, and might welcome this model. Another useful model in this vein is that of the US-China Economic & Security Review Commission. Canada should also play a leadership role in discussions within the Trans-Pacific Partnership talks (in which Malaysia is a negotiating party) and other trade and investment negotiations where the conduct of SOEs is on the agenda.

## Conclusion

If Canada wants to benefit from Asia's long-term growth potential, there is no getting around the need to facilitate trade, investment and other exchanges with China – and with other economies where the state plays a determining role. Naturally, this does not mean unconditionally accepting Chinese or other investments when there are grounds to question the character or governance practices of an investor, or to think that a particular investment would negatively impact Canada's interests with regard to national security or a competitive marketplace, or governments' ability to raise revenues or to implement public policy. Indeed, the CNOOC and Petronas cases demonstrate that these factors, rather than the mundane undertakings more typically required under the current net benefit test, are what matter most for assessing foreign direct investments in Canada.

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This E-Brief is a publication of the C.D. Howe Institute.

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