State-Owned Enterprises as Global Competitors

A CHALLENGE OR AN OPPORTUNITY?



OECD

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Foreword

The role of state-owned enterprises (SOEs) as global competitors is growing and this has given rise to concerns regarding their competitive situation. This report takes a multidisciplinary approach, looking at the issues from the competition, investment, corporate governance and trade policy perspectives. The report aims to "demystify" SOEs and develop a stronger understanding, based on empirical evidence, of how to address growing policy concerns with regard to the internationalisation of SOEs with a view to keeping the global economy open to trade and investment.

This work is part of an OECD project on SOEs in the Global Marketplace. The publication draws from various streams of work undertaken by the OECD bodies that have been involved in the project, including the Competition Committee, the Corporate Governance Committee, the Investment Committee, and the Trade Committee. Input was also provided by the Secretariat to the Steel Committee. It is informed by an informal taskforce of delegates represented across these bodies.

The report was prepared by Hans Christiansen and Sara Sultan Balbuena of the Corporate Affairs Division in the OECD Directorate for Financial and Enterprise Affairs, with contributions from the Competition, Investment, Trade Development and Steel Policy Divisions (Carole Biau, Mona Chammas, Antonio Capobianco, Anthony De Carvalho, Michael Gestrin, Przemyslaw Kowalski, Kateryna Perepechay, and Filipe Silva). Comments were provided Pierre Poret, Director of the OECD Directorate for Financial and Enterprise Affairs.

For more information on the project, readers are invited to visit the OECD website: *www.oecd.org/daf/ca/achievingcompetitiveneutrality.htm*

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Abbreviations and acronyms

ACCC	Australian Competition and Consumer Commission
BITs	bilateral investment treaties
BMF	Federal Ministry of Finance
BN	billion
BSC	British Steel Corporation
CAN	Canadian Dollar
CEO	chief executive officer
CIFUS	Committee on Foreign Investment in the United States
DPAG	Deutsche Post AG
DPW	Dubai Ports World
EC	European Commission
EDF	Électricité de France
EEA	European Economic Area
EU	European Union
FDI	foreign direct investment
FINSA	Foreign Investment and National Security Act
FOI	Freedom of Investment Roundtable
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GCI	government-controlled investor
GDF	Gaz de France
IIA	international investment agreement
IM&A	International mergers and acquisitions
ICSID	Convention on the Settlement of Investment Disputes between States and Nationals of Other States
IFRS	International Financial Reporting Standards
ISDS	investor-State dispute settlement
JFTC	Japan Fair Trade Commission

MOFCOM	Ministry of Commerce
MENA	Middle East North Africa
MEP	Ministry of Environmental Protection
MIGA	Multilateral Investment Guarantee Agency Convention
M&A	mergers and acquisitions
MNSOE	multi-national state-owned enterprise
NAFTA	North-American Free Trade Agreement
NTI	National Treatment Instrument
OECD	Organisation for Economic Cooperation and Development
OCPA	Office of Commissioner of Public Appointments
POE	privately-owned enterprise
PRA	Postal Reorganization Act
PTA	preferential trade agreement
RBC	responsible business conduct
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
SCMA	Subsidies and Countervailing Measures Agreement
SEK	Swedish Krona
ShEx	Shareholder Executive
SOE	state-owned enterprise
SSDS	state-state dispute settlement
STE	state-trading enterprise
SWF	sovereign wealth fund
TTIP	Trans-Atlantic Trade and Investment Partnership
TPP	Trans-Pacific Partnership
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States
USD	US dollar
US GAAP	US Generally Accepted Accounting Principles
USPS	US Postal Service
WTO	World Trade Organisation

Preface

The centre of gravity of the world economy is shifting as emerging market economies − some with large state sectors – come to play a growing role in the global marketplace. The deepening of commercial links and global value chains, as a result of trade and investment liberalisation, has opened the door to significant economic opportunities. However, this gravity shift has also created debate about economic models that rely to different degrees on state interventionism to achieve growth and industrial development. This report aims to provide greater clarity around some of the key issues.

The growing role of state-owned enterprises (SOEs) as global competitors is an important development. Today, 22 of the world's largest 100 companies are effectively under state control. This is the highest number we have seen in decades. The state in the marketplace is not necessarily a cause for concern. However, as the boundaries of markets increasingly extend beyond geographic borders, there is a risk that interventionist approaches spill over and compromise the global competitive landscape. An example is the current excess capacity in the steel sector, a consequence of, among other things, government policies directing capital formation towards less efficient activities.

Other concerns include the transparency and independence of companies that sit close to policy makers and the economic impact of any preferential treatment that they may enjoy. Some observers have also questioned the political motivation underlying corporate acquisitions by SOEs, as well as their apparent reliance on state-backed debt financing. Since some of the largest mergers and acquisitions involve state-owned or state-controlled companies as acquirers, governments must address such concerns. Otherwise, policy makers risk reverting to their bluntest policy instrument − protectionism − which would close a door on opportunities that promote economic prosperity, development and inclusive growth.

This study seeks to inform the policy debate. It sets out how, in response to these concerns, considerable progress has been made towards improved governance practices and efforts to level the playing field. This includes adhering to high standards of governance and transparency, such as those

enshrined in the recently revised OECD Guidelines on Corporate Governance of State-Owned Enterprises. Other achievements include more harmonised competition laws and policies, and disciplines covering SOEs in recent trade and investment agreements.

While these legal instruments provide policy makers with a range of tools, OECD analysis underlines the need to continue pursuing policies that foster openness, transparency, and non-discrimination. The OECD will strengthen its efforts to identify good practices for governments whose SOEs operate internationally, and support the implementation of these good practices. The policies of recipient countries also merit further attention, notably the degree of transparency and disclosure that is expected from foreign SOE investment entrants and trading partners.

Prosperity for all depends on markets that are open to trade and investment. It is our duty to ensure that they remain so. I hope this study can serve as an important contribution to that effort.



Angel Gurría
OECD Secretary-General

Executive summary

State-owned enterprises as global competitors

An estimated 22% of the world's largest 100 firms are now effectively under state control, the highest percentage in decades. Many of these operate in sectors with important upstream and downstream roles in international supply chains, such as public utilities, manufacturing, metals and mining, and petroleum. An important channel for the rapid internationalisation of state-owned enterprises (SOEs) has been cross-border mergers and acquisitions (M&A). Since 2007, M&A activity by SOEs has grown rapidly - especially from emerging markets - with a notable surge during the 2008-09 economic and financial crisis, and with continued growth compared to overall M&A or foreign direct investment. Emerging market economies with important state sectors are expected to grow more briskly than average for the foreseeable future, and their international investment will increase in parallel. Moreover, the deepening of international commercial links, suggest that SOEs are likely to remain a prominent feature of the global marketplace.

The upsurge of SOEs as global competitors has given rise to concerns about a level playing field. Some claim that preferential treatment granted by governments to SOEs in return for public policy obligations carried out at home can give SOEs a competitive edge in their foreign expansion. This study takes a multidisciplinary approach, exploring the issues from competition, investment, corporate governance and trade policy perspectives. It demystifies SOEs and develops a stronger understanding, based on empirical evidence, of how to address growing policy concerns about SOEs' internationalisation. The report concludes that although there is no clear evidence of systematic abusive behaviour by SOEs as global competitors, frictions do need to be addressed, in order to keep the global economy open to trade and investment.

Key findings

The international expansion of SOEs has given rise to a broad range of competition concerns. In an ever more open and globalised economy, state interventionist policies (assuming that there is a policy rationale for them) can have

beggar-thy-neighbour effects. This is especially true of state intervention sectors with important upstream and downstream roles in international supply chains. The main concern are:

- **Do SOEs always operate on a level playing field?** There are strong perceptions among policy makers and business people – and some, more limited, pieces of empirical evidence – suggesting that SOEs in the global marketplace do not always operate on a level playing field. SOEs are perceived as having lower financing costs, whether due to concessionary loans from state-related financial institutions or agencies, the acceptance of unusually low rates-of-return or dividends by their government owners or, as is almost universally the case, preferential loans by private financial institutions who perceive a low risk when lending to a government-related entity. In the case of international investment this may be a source of additional advantage because it enables the funding of individual transactions.

- **Harmful spill-overs of compensation and special advantages granted by governments in return for public policy obligations at home.** The rationale for state ownership of enterprises is often that these enterprises are expected to act differently from private firms in like circumstances. These objectives often consist of the provision of certain public services to a domestic constituency. However, in some cases they may spill over to other jurisdictions – for instance where continued "life support" to an ailing SOE keeps alive what from an overseas perspective may be an unwelcome competitor; or where subsidised over-production might lead to excessive capacity. If the public policy objectives directly target foreign jurisdictions (e.g. information gathering, acquisition of sensitive technologies, establishing a strategic position in certain market segments) in the interest of the SOEs' home countries then they may be badly perceived by partner countries. This further raises concerns as to whether such SOEs could claim foreign sovereign immunity, which remains prominent on the radar screens of regulators.

- **Asymmetric contestability in home markets for foreign competitors.** In the context of fostering cross-border competition in the network industries, the presence of large incumbents (which are usually, but not necessarily, state-owned) has in some cases effectively impeded the entry of foreign competitors. Where the incumbents retain an element of legal monopoly in the public interest this may be defended as an exercise of the national authorities' right to regulate, but if competition is in principle allowed and the incumbent is kept in place mostly though preferential treatment then this marks a serious departure from the

principle of competitive neutrality and may furthermore establish asymmetric contestability for markets.

Policy options

Protectionism is a risk if these concerns are not addressed. Policy makers have an interest in keeping the international trade and investment environment open and transparent, so long as all economic actors are operating on a level playing field. Concerns about the SOEs' competitive situation need to be addressed through self-regulation and more binding commitments taken at all levels: domestic, supranational or multilateral. Policy options include:

- **Address distortions that may arise from state intervention at the domestic level.** This includes ensuring equal treatment of companies, both domestic and foreign, under competition law and policies, and putting into place competitive neutrality frameworks and rules on state aids to ensure that policies in one jurisdiction do not advertently or inadvertently impact the competitive environment in others.

- **Promote high standards of governance, disclosure, accountability and transparency for SOEs.** SOEs that intend to expand internationally should be subject to high standards of governance, in line with the internationally accepted OECD Guidelines on Corporate Governance of State-Owned Enterprises. For broad application, a wide range of emerging countries should be encouraged to adhere to the SOE Guidelines; and a regular implementation mechanism should apply.

- **Recipient countries investment policies should be non-discriminatory and transparent towards SOEs**. National investment policies should ensure greater transparency and predictability, especially where additional measures or screenings relating to national security or public interest considerations may apply. In addition, gaps in the coverage of investment policy concerning a level playing field might be addressed.

- **Governments should seek to identify and remedy gaps in the coverage of multilateral rules regarding trade distorting government and enterprise behaviour**. For example, in the context of the WTO, rules on subsidies granted to and by state enterprises might be a priority for further deliberations.

Chapter 1

State-owned enterprises as global competitors

This chapter describes the main issues and definitions covered by the report. It provides an empirical overview, based on original OECD analysis, of the share of state-owned enterprises (SOEs) in the global economy, their geographical and sectorial concentration, and their value among the world's largest firms. The data points to a marked rise in the share of SOEs as global competitors, and as such discusses how the international expansion of SOEs has triggered concerns regarding their competitive situation. It compares perceptions of concerns, based on original survey data, across business, industry and regulation. Finally, the chapter zooms in on the steel sector, with an overview of recent analysis of steel markets, the role of SOEs in steel production and their financial performance.

1.1. Internationalisation of enterprises: Does ownership matter?

When analysing the issue of internationalisation of state-owned enterprises (SOEs) two questions inevitably impose themselves. First, how does one define SOEs in a world where public authorities may own different sizes of equity stakes in different enterprises, where corporations may be under strong government influence even in the absence of ownership stakes, and where a number of public institutions that would normally not count as enterprises may nevertheless be active in the marketplace? Secondly, to what extent does state ownership constitute a stand-alone issue, and merit specific address, in a global economy where many of the regulatory and policy concerns relate to the risk of beneficial treatment that can equally be bestowed on private companies? In addition one may also need to consider the degree to which these distinctions differ according to national and economic context.

Toward a definition of SOEs. This document proposes a broad definition of state ownership. The issue is addressed in OECD's 2015 "Recommendation of the Council on Guidelines on Corporate Governance of State-Owned Enterprises" [hereafter referred to as the "SOE Guidelines"] (OECD, 2015a), which is discussed in detail in a later section. Most countries may define SOEs strictly as entities recognised by national law as enterprises in which the state is the ultimate beneficiary owner of the majority of voting shares. However, a number of borderline cases impose themselves. For instance, the state may not be the majority owner of a given enterprise but nevertheless exercise a similar degree of control over the enterprises. In the words of the SOE Guidelines "examples of an equivalent degree of control would include, for instance, cases where legal stipulations or corporate articles of association ensure continued state control over an enterprise, or its board of directors, in which it holds a minority state. Some borderline cases need to be addressed on a case-by-case basis. Whether a "golden share" amounts to control depends on the extent of powers it confers to the state. Also, minority ownership by the state can be considered as covered by the [SOE] Guidelines if corporate or shareholding structures confer effective controlling influence on the state (e.g. through shareholders' agreements)… Throughout the [SOE] Guidelines, the term "ownership" is understood to imply control". A similar approach is applied by in the remainder of the present document: where the state in effect exercises control over an enterprise (other than through *bona fide* regulation) this enterprise is considered as an SOE.

Does state ownership/control exacerbate concerns about market distortions in the global marketplace? Trade, investment and competition regulators are mostly concerned with market distortions arising from

irregular or disruptive corporate practices. Such practices (along with national governments' ability to favour "national champions" and other priorities corporations) are by no means limited to SOEs. However, state ownership (or control) of enterprises does potentially matter in the context of their cross-border operations. Two of the most direct points of relevance are:

- *SOEs acting as agents of a sovereign government.* As frequently argued in academic literature, one of the salient points that separate SOEs from other enterprises is that SOEs are not necessarily (dependent on the priorities communicated to them by their government owners) expected to maximise profits and long-term corporate value[1]. Indeed, the rationale for continued state ownership would often be that these enterprises are expected to act differently from private companies in like circumstances. Insofar as such "public policy objectives" (in the parlance of OECD) are confined to the domestic economy of the SOEs – and subject to adequate disclosure and funding arrangements – then this need not concern foreign jurisdictions provided that any anti-competitive effects are limited to the domestic economy and agreed to fulfil a public interest objective or correct a market failure. However if, by accident or design, SOEs act abroad to the detriment of economic interests of other countries (in a way that spills over into a SOEs international operations and which may have an anti-competitive effect) and expressly designed to benefit the public interest of their home countries (possibly at the detriment of public interest in the partner country) then a number of issues arise for regulators and policy makers in the partner countries.

- *Disclosure and transparency*. Whereas governments may equally grant subsidies and beneficial treatment to private firms (or persuade them to depart from common commercial practices in the "national interest"), where SOEs are involved additional issues of transparency arise. For instance, depending on the ownership and governance arrangements (notably how closely SOEs are held by the general government sector) preferential treatment may be significantly harder to detect than when the beneficiary is a private enterprise. This issue is generic to any situation where SOEs compete with private firms, but it may be compounded by cross-border operations because foreign regulators may find it harder to obtain the necessary information and, in some cases, the necessary degree of regulatory cooperation from the authorities of the SOEs' home countries.

Countries operating at different levels of economic development or organised according to different economic models. The relative importance of state ownership has arguably changed in recent decades because the

international economy has to an increasing degree seen competition among countries operating at different levels of economic development. This is important because the role(s) assigned to SOEs generally change as countries develop their economies. At early stages of economic development SOEs (or even privately-owned national champions benefitting from government support) are often perceived as an economic necessity because they provide basic services and goods to which there are no privately provided alternatives. In emerging economies state interventionism (including, but not limited to, the operations of SOEs) is often employed to stimulate growth via national development strategies and industrial policies. When the business sectors of countries with a large share of SOEs expand abroad, their trade and investment partners may find that they need to address unfamiliar issues of SOEs in the marketplace in sectors where they themselves had, decades earlier, phased out or limited all public sector involvement. Trade and investment partners may also grapple with the incertitude as to whether any advantages conferred upon SOEs in the home jurisdiction have not been carried over into the international operation of the SOE, and thus resulting in an anti-competitive effect in the partner's market.

1.2. Large SOEs: An empirical overview

The role of SOEs in the global economy is rising, reflecting not only the internationalisation of SOEs but the fact that these enterprises make up for a significant proportion of many of the world's fastest-growing economies. According to earlier studies by OECD and the World Bank, it is not uncommon for the SOE sectors in even relatively advanced emerging economies to account for 20-30 per cent of economic activity, and in resource-dependent and/or small developing economies the share can be significantly higher.

In most OECD countries the share is much lower; SOEs owned by the central level of government typically make up for around 2 per cent of economic activities (OECD, 2014b)[2]. However, this may not provide an adequate picture of the state's involvement, via SOEs, in these countries' economy. First, following decades of privatisation the remaining SOE portfolios tend to be strongly concentrated, mostly in the utilities sectors, network industries and in some cases finance. In exercising control over these sectors, on which most of the private sector economy depends for its productivity and competitiveness, governments may if they chose continue to exercise a disproportional economic influence. It also has direct implications for the internationalisation of SOEs since, particularly within the European Union, SOEs in these sectors have been particularly active in cross-border trade and investment.

The impression of a significant continued state influence strengthens when one includes partially-state owned enterprises (also known as state-invested enterprises) in which the state retains an ownership share that is large enough to wield considerably corporate powers. This is commonly assumed to be the case when the ownership share exceeds 10% of the voting shares[3]. An earlier study (OECD, 2014e) shows if this broader definition is applied then four OECD countries (Norway France, Slovenia and Finland) have state-invested sectors accounting for more than 10% of the economy[4].

The national and sectorial distribution of the world's largest state-invested enterprises is shown in Table 1.1. The ranking, based on the 2015 Forbes 2000 Global ranking of companies, shows that in 2014 no less than 326 of the world's largest 2000 firms had the state as an owner of more than 10% of their shares[5]. According to the table, more than a third of the world's largest SOEs in 2014 (a total of 128) were mainland Chinese, with an additional 13 domiciled in Hong Kong, China. A further description of China's corporate and SOE sector is provided in Box 1.1. OECD countries also figure prominently in the table, with a total 33 big SOEs found in the largest European countries plus Norway and Japan. The remainder is accounted for largely by emerging and post-transition economies, including India (34 SOEs), the Middle Eastern countries (29), Russia (10) and Brazil (7).

The most important sector by far is finance (banking and other) with a total 115 in the top-2000. This is followed by public utilities (electricity, gas distribution, transport and communication) with 83 SOEs, manufacturing (41), metals and mining (29) and petroleum (26).

Table 1.1. **National and sectoral distribution of the world's largest state-invested enterprises**

Economy	Number of enterprises										Total sum of market value (US$ mill.)
	Banking	Electricity & Gas	Manufacturing	Other financial	Metals & Mining	Petroleum	Communications	Transportation	Others	Total	
China	18	10	23	18	17	5	4	7	26	128	4 004 308
France	1	3	5	1			1	2		13	384 700
India	16	4	2		4	4	2		2	34	330 557
Germany	1	2	1				2			6	290 000
Saudi Arabia	2	1	3	1	1		1			9	210 400
Hong Kong, China	1	3	1	3	1			3	1	13	209 600
Russia	2	3			1	3	1			10	188 100
United Kingdom	2									2	144 600
Singapore	2						1	1	2	6	143 715
Norway	1		1		1	1	1			5	141 500
Japan							1		1	2	136 700
Italy		3	1			1				5	128 500
U.A.E.	6	1		2			1	1		11	123 500
Brazil	1	2	1		2	1				7	121 600
Qatar	5		1	2			1			9	110 100
Others	25	11	2	5	2	11	8	2	0	66	788 400
Total	**83**	**43**	**41**	**32**	**29**	**26**	**24**	**16**	**32**	**326**	**7 456 280**

Source : Forbes Global-2000. Only countries whose state-invested sectors have a market value exceeding US$ 100 bn are included.

Box 1.1. **Central vs. local SOEs in China: Different motivations and sector focus**

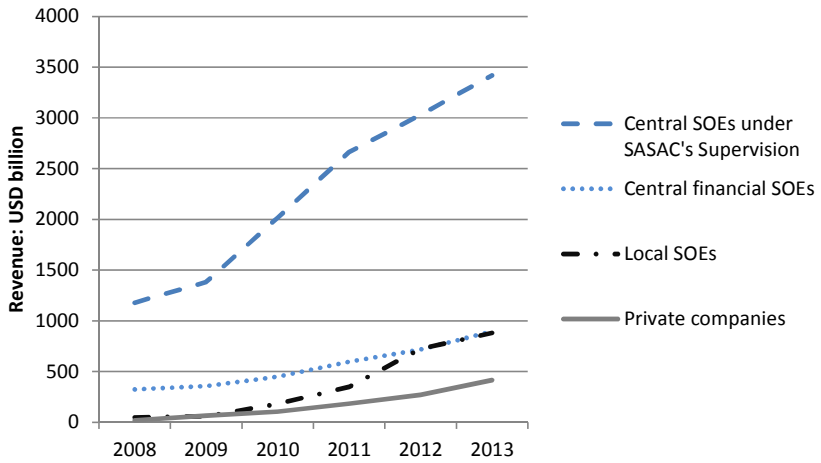
One of the first steps to understanding investment by Chinese SOEs is the distinction between central SOEs (which tend to be concentrated in strategic industries) and the myriad of provincially and locally owned SOEs. China's largest companies are almost all central SOEs and state owned banks. Of the top 50 firms in 2011, central SOEs control 72% of the total revenue, with other central financial enterprises and the post office making up a further 17% (Hubbard & Williams, 2014). These central SOEs are under the supervision of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), and occupy an important place in the national economy as a whole, as well as in the (non-financial) state sector.

The number of central Chinese SOEs has decreased from 196 in 2003, when SASAC was set up, to 112 at the end of 2014. Turnover grew 9.1% in 2013 and 3.8% in 2014, while total profits increased 3.6% and 4.2%, respectively. They account for 31.3% of total assets of (non-financial) SOEs, 49.4% of total profits of (non-financial) SOEs, and 34.1% of (non-financial) SOEs' employment in 2012. The turnover of all central SOEs is equivalent to 39.4% of China's GDP in 2014. These (non-financial) central SOEs are concentrated in sectors of "strategic" importance to the economy, notably natural resources and public utilities (energy, telecoms, transportation, etc.). In 2014, these central SOEs account for 64.1% of total revenues of Chinese Fortune 500 enterprises (OECD, 2015l).

This contrasts with the overwhelming majority of Chinese SOEs, at provincial and local levels. Although put together they control more state equity than central SOEs, they are generally much smaller (see Figure 1.1 below). Nonetheless they are quite actively involved in international transactions, especially in Europe. In fact the Transnationality Index (TNI, calculated as the arithmetic average of the foreign-to-total ratios of assets, sales and employment) for local Chinese SOEs has been catching up to that of central SOEs: from a TNI of 7.04% in 2010 for local SOEs (compared to 11.87% for central SOEs), in 2013 there was only a 1% difference in the TNIs, which both stood at around 13%. In addition to this rapid internationalisation, there is also a definite sector concentration for investments by local SOEs: over 2010-2013, more than 70% of transactions made by local Chinese SOEs in Europe were in the manufacturing sector.

Provincial SOEs operate in highly fragmented environments, with supervision spread across 36 provincial-level asset management commissions and 442 sub-branches (Drysdale, 2015). Local SOEs are also far more likely to be competing against each other as well as with private firms – and therefore have more commercial incentives than central SOEs. However, they may be subject to less stringent supervision than central SOEs.

Figure 1.1. **Chinese enterprises listed in Fortune Global 500 ranking, by revenues**

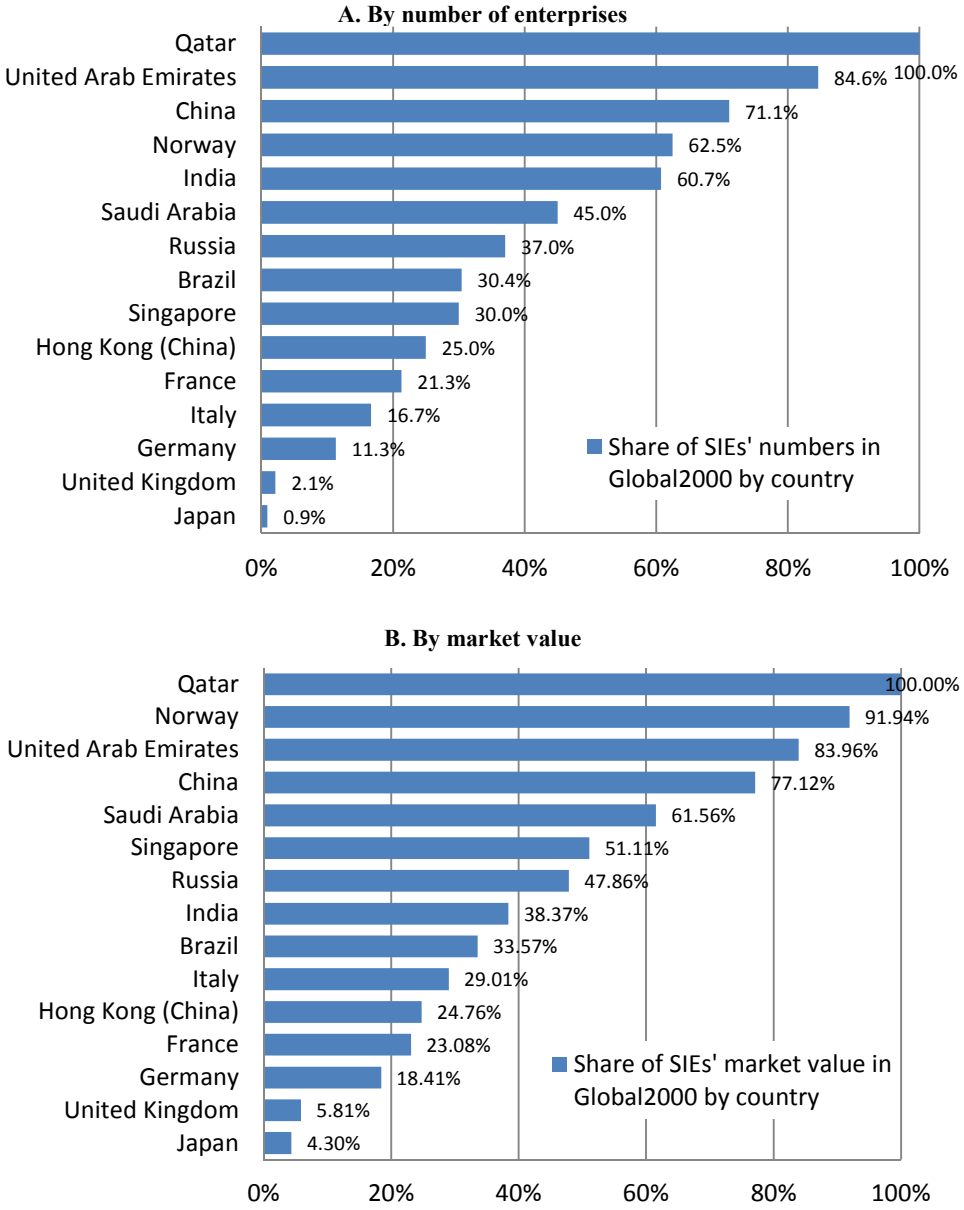


Sources: Secretariat calculations based on Dealogic M&A Analytics database. OECD (2015l), Zhu Kai and Andrea Goldstein, "Chinese Central SOEs' Investment in Europe and France: Overview and Impact". Hubbard, Paul and Williams, Patrick (2014). "Chinese SOEs: some are more equal than others". East Asia Forum Quarterly, 24 August 2014.

The prevalence of large SOEs in individual countries is of interest in the context of identifying the locations that are most likely to act as sources of outward trade and investment by such companies. However, it provides at best a piecemeal impression of the importance of SOEs in these countries' business sectors. Figures 1.2.a and 1.2.b illustrate the share of top-2 000 enterprises across countries that are owned or invested by the state. The two figures provide alternative measures based on a count of the number of enterprises and the respective market values[6].

The figures show that in the relatively small Gulf monarchies Qatar and United Arab Emirates virtually all the largest enterprises have the state as a significant shareholder. When measured by market value Norway also appears very close to 100%, but this mostly reflects a very high valuation of its state-owned petroleum producer. Regardless of measures China figures as having a very high percentage of its large enterprises (well over two-thirds) under majority or, in some cases, partial state ownership. Conversely, while the large European economies – and to a certain degree Japan – figure prominently in Table 1.1 the relative share of SOEs in their corporate sectors (or, rather, the top echelons of their corporate sectors) appears relatively limited.

Figure 1.2. **Share of state-invested enterprises of total enterprises in Global-2000, at end-2014**

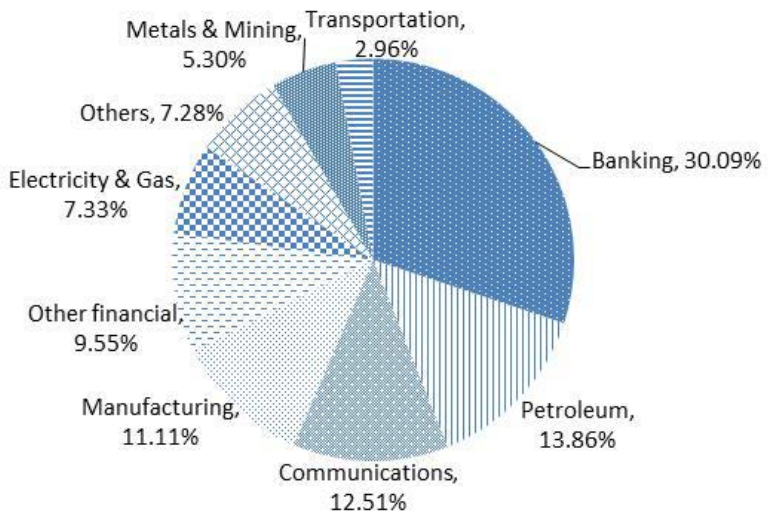


Source: Forbes Global-2000. Only countries whose state-invested sectors have a market value exceeding US$ 100 bn are included.

A further observation from Figures 1.2.A and 1.2.B is that the relative weight of SOEs in individual countries appears greater when measured by value than by numbers. This is consistent with OECD (2014b) which found that in most countries the prominence of SOEs is most pronounced among the absolutely top sized companies. One notable outlier in this respect is India, where the large SOEs appear to be generally smaller than comparable private companies. This probably attests to the prominence of very large family owned corporate groups in the Indian economy and among stock listed companies.

Finally, Figure 1.3 provides a breakdown of all the world's largest 326 state-invested enterprises (measured in terms of market value) according to main sector of operations. It turns out that, globally, the picture is dominated by the financial sector (more than 41% of total market value), which can be attributed principally to a number of Chinese banks and insurance companies, secondarily to minority state shareholdings in a several very large West European banks. In second place comes the petroleum sector (essentially national oil and gas exploration companies) with close to 14% of total market value, and in third place is the communications sector (mostly telecom) which represents almost 13 per cent. This is of importance for the remainder of this report because these are sectors that – including in the case of private ownership – tend to have a high incidence of overseas trade and investment.

Figure 1.3. **Sectorial breakdown of world's largest SOEs**



Source: Forbes Global-2000.

1.3. A summary of key concerns related to SOEs as global competitors

Part of the concern related to the internationalisation of SOEs, for regulators and private competition, is that SOEs may not behave like private firms in their international operations, and decisions may not be driven by business objectives and the underlying creation of economic value. A primary concern is that trade and investment by SOEs may be driven by "political" or public policy goals rather than, or in addition to, commercial consideration. In other words, SOEs (even if they enjoy managerial autonomy and limited governmental interference) have to factor in political goals and non-business motivations of their state owners (Cuervo, 2014).

It is generally accepted that if governments make a conscious decision to own an enterprise then it must be assumed that this enterprise is under some circumstances required to act in a different way from private companies. Usually the motivation is the delivery of public service obligations such as, for example, universal coverage and general affordability in the utilities sector; or to remedy market imperfections. A number of emerging economies also assign an active role to state-owned enterprises in their development strategies and in industrial policy. SOEs may be acting on behalf of their government owners to secure control over scarce resources in the broader national interest. SOEs may also be buying into foreign technologies and knowhow with the purpose of diffusing them widely in the domestic economy.

A point of contention arises from the fact that a number of SOEs that are active in economic markets continue to pursue commercial as well as public policy objectives, and that the division between the two is not always transparent. In return for accepting various non-commercial tasks, SOEs are generally granted certain compensations by their government owners. They are often granted regulatory exemptions (e.g. allowed to maintain monopolies), given access to cheap finance (Kowalski, P. and K. Perepechay, 2015), granted tax concessions, etc. [7] If not accounted for in transparent way – as recommended in the OECD Guidelines on Corporate Governance of SOEs (OECD, 2015a) – compensation and special status can raise concerns.

As SOEs expand into the competitive economies of other countries, these various forms of compensation can give rise to problems. In particular, some of the concerns relate to spill overs from a privileged position in the home market into the SOEs international operations. Some of the advantages granted to SOEs by governments (or provided to private firms via SOEs) can create anti-competitive effects in the global marketplace. Such effects may be by accident or by design. Poorly designed or distortionary compensation schemes are not uncommon whereby SOEs are

granted advantages that are proportional with their business volume rather than their public policy objectives – which gives them both an incentive and an edge in foreign expansion. Even a highly reactive effort to stave off the default of an ailing SOE may be perceived negatively by foreign observers, from whose perspective this prevents the disappearance of a competitor. Depending on their scale and recurrence, these actions can have an impact on global resource allocation challenge commonly accepted principles of international competition and of the multilateral trading and investment system. It should be noted that these concerns are not necessarily limited to SOEs, they can also relate to behaviour of state-favoured privately-owned firms. These advantages are summarised in a tabular form below.

Types of Preferential Treatment	**Description**
Preferential financing from SOEs, state banks or other (state-backed) financial institutions	Preferential financing can entail: (i) favourable requirements with respect to rate-of-return on capital of SOEs; (ii) favourable requirements with respect to dividends of SOEs; (iii) direct financial state support (not linked to public service obligations); (iv) recapitalisation of SOEs at lower than market rates; (v) provision of credit below the market interest rate; and, (vi) provision of state-backed guarantees. This concern can extend to preferential lending by state-owned financial institutions to private companies (e.g. for the expansion/maintenance of their production capacities).
Privileged access to information	If SOEs are privy to privileged information from governments, including classified intelligence, confidential cabinet decisions, etc. then this could be perceived as an unfair advantage and can have an impact on market confidence. SOEs may also be perceived to have access to data and information which are not available to their private competitors or only available to a limited extent (i.e. planned regulation, procurements, technical specifications, sanitary rules, environmental policies, laws, taxation initiatives)
Outright subsidies/Tax concessions	Some SOEs receive direct subsidies from their government or benefit from other public forms of financial assistance to sustain their commercial operations. For example, tax concessions can often be found in the form of schemes aimed at compensating SOEs for their public services obligations at home (e.g. delivery of postal service or transport services in remote areas which would not be commercially viable); however, if schemes are proportional to the business volume

Types of Preferential Treatment	Description
	rather than public service obligations themselves this can be seen as a form of preferential treatment and tantamount to selective government subsidies.
In-kind subsidies	Another form of subsidisation is in kind benefits, for instance where state-owned operators in the network industries receive benefits such as land usage and rights of way at a price significantly below what private competitors would have had to pay in like circumstance. These exemptions artificially lower the SOEs‟ costs and enhance their ability to price more efficiently than competitors subject. Other examples include preferential access to inputs such as labour and infrastructure.
Grants and other direct payments	Grants or other direct payments can include: (i) policies that support R&D; environmental and green programmes ; (ii) general economic development policies (e.g. industrial policy); (iii) sector or product-specific economic development policies; and, (iv) support for the provision of public services; all of which if not provided equally to competitors on the same market could create a non-neutral situation.[8]
Privileged position in the domestic market	In many cases, governments entrust SOEs with exclusive or monopoly rights over some of the activities that they are mandated to pursue. This can be seen, for example, in postal services, utilities and other universal services that the state decided to pursue through state-controlled entities. Where SOEs continue to benefit from a legal or natural monopoly this may be of little practical consequence for the competitive landscape, but a number of SOEs in the network industries operate as vertically integrated structures with incipient monopolies in parts of their value chains. This can have a direct effect on relative competitiveness, and it may also allow them to influence the entry conditions of would-be competitors across a number of commercial activities. Moreover, concerns may arise as to preferences towards SOEs in domestic public procurement.

Types of Preferential Treatment	Description
Explicit or implicit guarantees	State guarantees for SOEs, can be of concern if they reduce the cost of borrowing and enhance their competitiveness vis-à-vis their privately-owned rivals. In practice, it can be difficult for the state to convince markets that a given enterprise is not subject to such guarantees.
Exemptions	SOEs in some sectors and/or some corporate forms may enjoy outright exemptions from bankruptcy rules. This is of concern because equity capital is locked, and SOEs can generate losses for a long period of time without fear of going bankrupt. Exemptions from anti-trust enforcement can also create opportunities for SOEs to engage in anti-competitive behaviour. For example, it may allow SOEs to engage in predatory behaviour.
Preferential regulatory treatment	SOEs which are not subject to the same regulatory regimes as private firms can lower their operating costs. This can entail: (i) simplified procedures to obtain licences or permits; (ii) granting of special rights to extract resources; (iii) exemptions for application of general laws and regulations; (iv) exemptions from regulatory compliance (e.g. environmental or technical specifications); (v) exemptions or non-compliance with information disclosure requirements; (vi) unjustified denial of approvals to potential competitors; (vii) exemptions from building permits or zoning regulations; and, (viii) obtaining of grandfather clauses.
Preferential treatment in public procurement	Preferential access to information about upcoming public procurement contracts and tenders (i.e. technical or other specifications essential for awarding the contract); or outright favouritism of SOEs in awarding contracts can give an upper hand to a SOE vis-a-vis a potential competitor..
Price support	Price support is with regard to policy measures that can create a gap between domestic market prices and reference prices of a specific commodity.
Support in the form of commercial diplomacy	Reliance on the government's backing and diplomatic relations to pursue business opportunities, otherwise not commercially possible without such support or not available to competitors, can give SOEs an upper hand vis-a-vis competitors.

1.4. Comparing perspectives among business, industry and regulation

The following sections attempt to compare concerns voiced by the business, industry and regulation. It is based on two separate survey exercises conducted by the OECD. The first part (section a) provides perspectives of trade policy makers, investment regulators and SOE owners based on the OECD *Survey on State-Owned Enterprises in the Global Marketplace*. The second part (section b) provides the viewpoints of private competitors based on the *OECD Business Survey on State Influence on Competition in International Markets.* The third part (section c) draws on perspectives from policy makers in the steel community.

a) The viewpoints of trade policy makers, investment regulators and SOE owners

Some of the concerns cited in the previous section have also been voiced in several contexts as documented in the OECD *Survey on State-Owned Enterprises in the Global Marketplace*. They survey conducted in 2015, covered 17 jurisdictions (representing mainly OECD member jurisdictions) and attempted to gauge the main challenges and concerns related to the internationalisation of SOE. The survey solicited information from government authorities responsible for enterprise ownership, competition enforcement, investment regulation and trade policy in addition to departments of government with broader responsibility for the enterprise and competition landscape, and/or cross-border trade and investment regulation. The purpose was to gauge the level of concern with regard to SOEs in the global marketplace; to understand whether these concerns emanate from preferential treatment in the domestic marketplace; due to the competitive situation of SOEs; due to a lack of information or uncertainty regarding transparency and governance of SOEs; or more specifically concerns related to national security. The survey also asked SOEs and their owners to evaluate the motives behind SOE investment and particular challenges faced in their overseas operations. The main outcomes of the survey are summarised as follows (Sultan Balbuena, 2016):

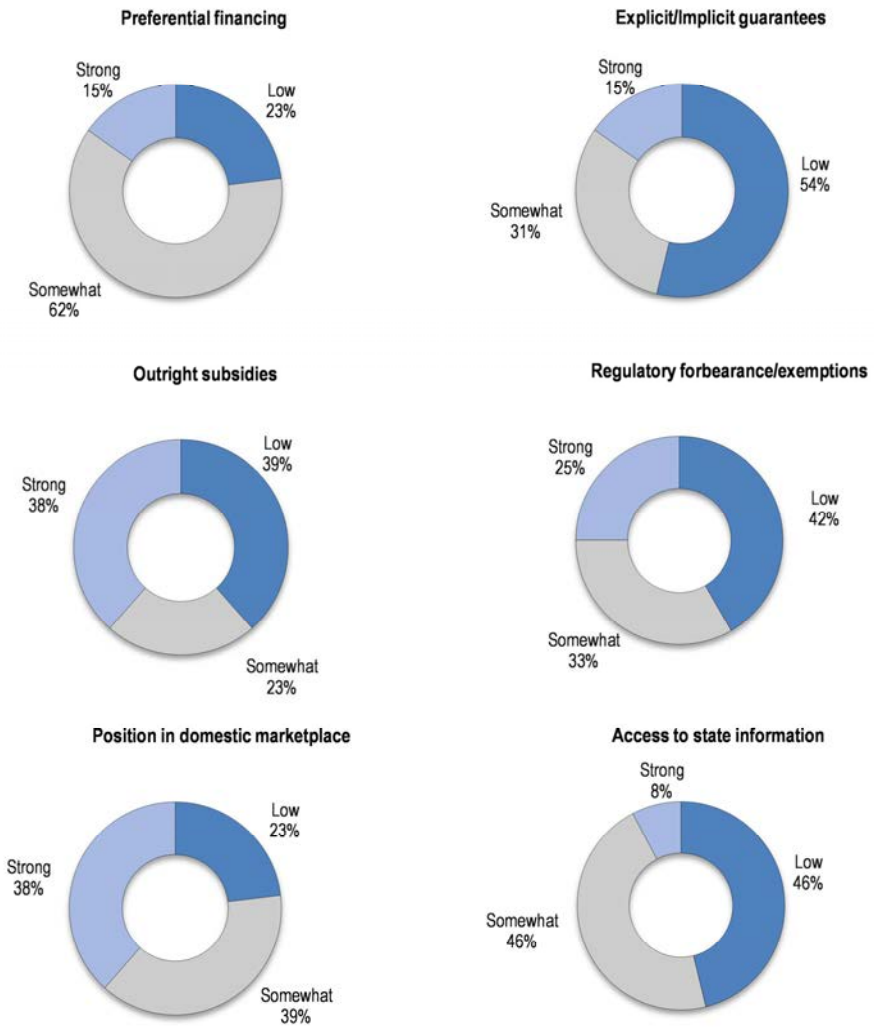
Public ownership may be a source of concern, but not for all policy communities. With regard to whether state-ownership can exacerbate concerns about market distortions in the global marketplace the survey yielded mixed results. From the investment regulation perspective, it would appear that public ownership is not a defining factor (86 per cent of respondents consider that SOE investments represent the "same level of threat" compared with privately-owned firms). From a trade perspective, it would appear that public ownership is a more defining factor with regard to distortions in the marketplace. Over 80 per cent of respondents consider that

SOEs are favoured by their governments (emanating more often than not from the local or sub-national governments), and more than 46 per cent report that SOEs are more prone to receiving advantages compared with privately-owned enterprises. 73 per cent of respondents consider that such benefits can have an impact on international trade in goods and services. From an SOE (or government owner) perspective, most respondents do not consider that particular hurdles in their overseas operations are related to their public ownership status. At the same time, respondents report that their overseas operations are met with political unease due to i) the presence of the government as a shareholder; and ii) perceived competitive advantages.

Preferential treatment received by and via SOEs is considered to be of concern. From an investment policy perspective, there were some or strong concerns regarding SOEs position in the domestic marketplace (77 per cent) and whether they are subject to competition enforcement. The main areas identified to be of some or strong concern were i) preferential financing (77 per cent), ii) outright subsidies (61 per cent); and, iii) regulatory exemptions (58 per cent) (Figure 1.4). The results with the trade community are strikingly similar. The forms of preferential treatment (granted to SOEs) with the "strongest" reported impact on competition included: preferential treatment in public procurement; price support; grants/direct payments; and tax concessions. Finally, advantages granted *by* SOEs were also considered to impact the playing field.[9] Digging deeper, it would appear that these concerns do not translate into any perceived anti-competitive conduct (i.e. with regard to anti-competitive mergers, cartels, monopolisation or abuses of dominance). Moreover, respondents do not perceive SOEs to be over or under paying for their acquisitions – a finding supported by recent empirical evidence.

Figure 1.4. **Examples of preferential treatment and level of concern**

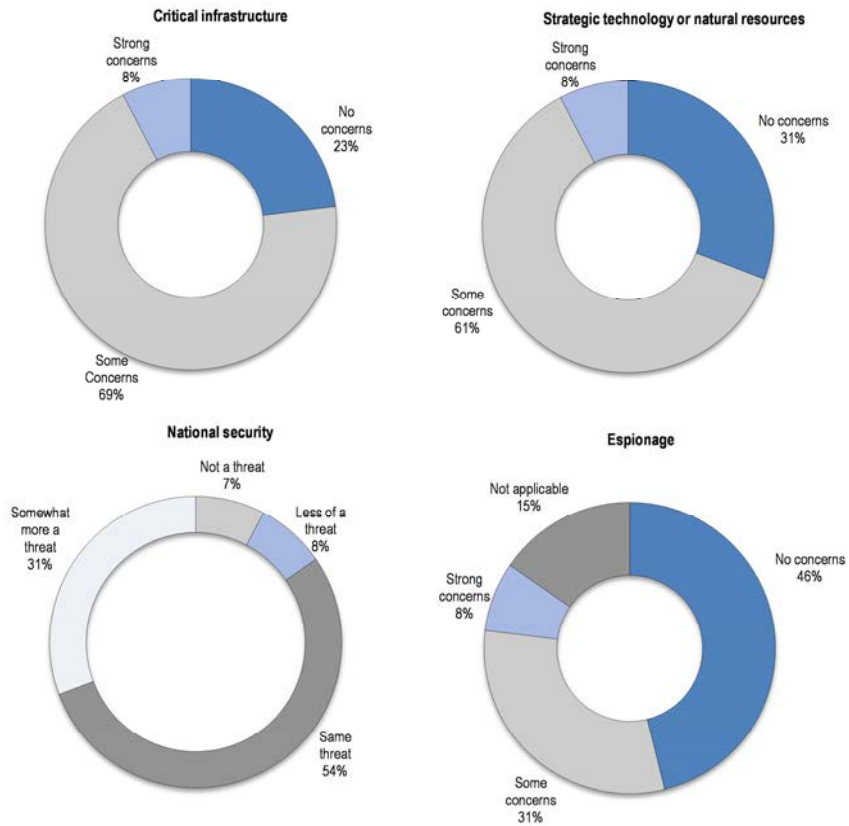
An investment policy perspective



Source: OECD Survey on State-Owned Enterprises in the Global Marketplace (2015).

Concerns over national security are mainly focused on critical infrastructure and strategic technologies/resources. Although representing only 30 percent of respondents,[10] national security concerns appear to have a strong sectorial element and may be exacerbated by foreign SOE investment in a small-sized economy. In particular, investments in critical infrastructures (energy, communication or heavy industry) and strategic technologies or natural resources were identified of strong concern (over 60 per cent of respondents). Concerns related to espionage were of reported by a smaller margin of respondents, and vary according to the country of origin of the investment. In general this finding would tend to support the hypothesis that regulators place more weight on "economic" concerns than other more onerous ones; and the sectorial bias may reflect trends in international M&A activity by SOEs (as noted above) (Figure 1.5).

Figure 1.5. **Concerns related to national security - a policy perspective**



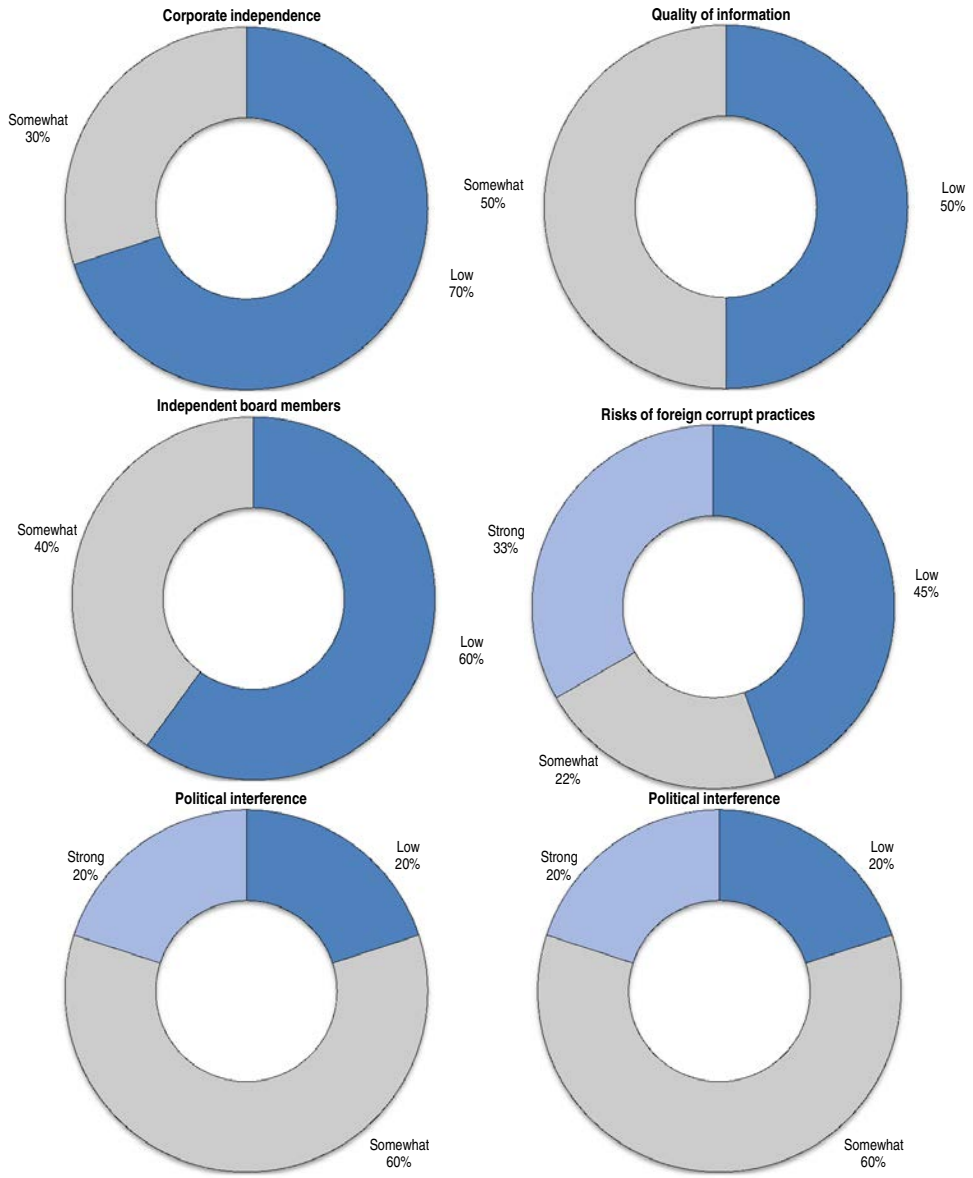
Source: OECD Survey on State-Owned Enterprises in the Global Marketplace (2015).

SOE governance and transparency practices; and access to information on SOE operations are considered important. 80 per cent of respondents indicate some or strong concerns about political interference in SOE' commercial operations. This may explain why regulators consider that accessing information on foreign SOE (company-specific objectives, state ownership policy, annual reports, etc.) is important to ensure that i) SOEs operate independently and autonomously from the state; and ii) to quell any potential concerns regarding non-commercial objectives underpinning SOE operations in a foreign jurisdiction. As a corollary issue, the risks of SOE being embroiled in foreign corrupt practices also ranked high among concerns of regulatory authorities (Figure 1.6). SOEs (and their government owners) report that their overseas operations are met with political unease. From a trade policy perspective, clarity around corporate governance practices and non-commercial objectives were considered important for SOE owners to consider. Respondents do not perceive any observable differences in their ability to determine preferential treatment among SOEs and POEs. Whether this can be attributed to adequate access to information and transparency around SOE operations is left an open question.

No perceivable differences in the motivations and challenges faced by SOEs, as compared with private companies. The main motivations behind cross-border trade and investment reported by SOEs (and government owners) are related to i) profit generation; ii) commercial/industry specific factors; iii) and, broader internationalisation strategy. SOEs and their owners report that their overseas operations can contribute to employment creation and the development of new industries. Most responding jurisdictions, report concerns faced in their overseas operations when it pertains to i) restrictions imposed by investment of trade agreements, ii) treatment in administrative or regulatory procedures; ii) where specific industry restrictions may exist; and, iv) treatment in public procurement processes (Figure 1.7). These challenges were not perceived to be different for SOEs as compared with private companies. SOEs report positive outcomes in their international operations when information is provided on the company's commercial objectives; governance structures and ownership mechanisms; in addition to disclosing financial and non-financial information. Respondents also consider their *responsible business conduct* commitments to be an important legitimacy-enhancing factor.

Figure 1.6 **Concerns about SOE Governance**

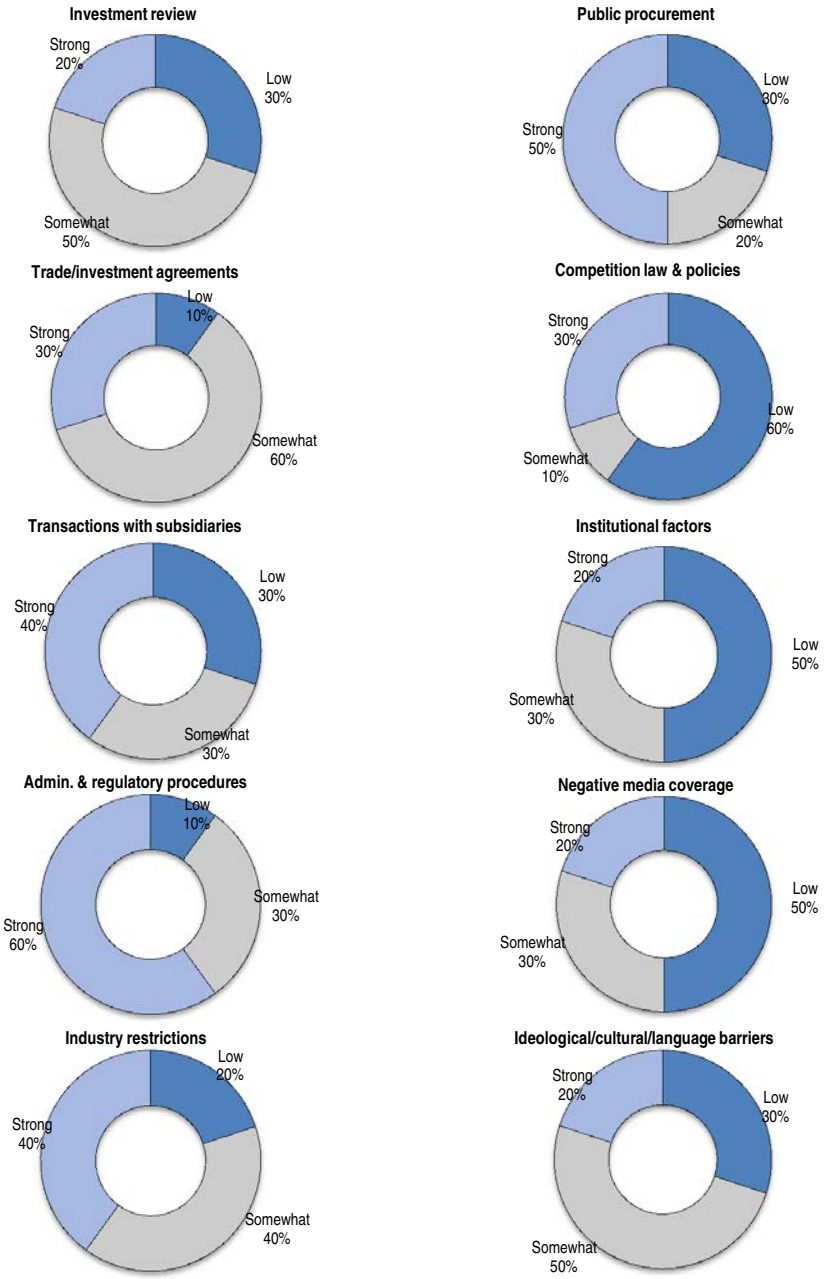
Aspects that may influence the decision to allow a foreign SOE to operate in your jurisdiction



Source: OECD Survey on State-Owned Enterprises in the Global Marketplace (2015).

Figure 1.7. **Concerns of SOEs and their government owners**

Related to foreign operations



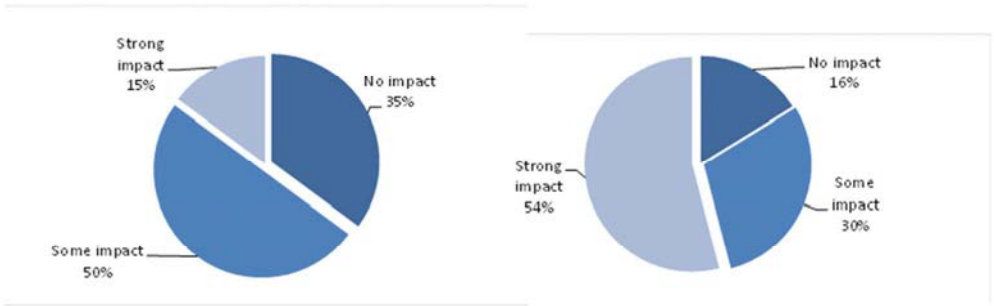
Source: OECD Survey on State-Owned Enterprises in the Global Marketplace (2015).

b) The viewpoints of private competitors

Some of these concerns have also been voiced in several contexts. The *OECD Business Survey on State Influence on Competition in International Markets* conducted on 157 firms in 2014 attempted to characterise these sentiments in a more systematic manner. The survey solicited information on crucial policy questions and issues raised in the literature and on-going discussions on cross-border activity of state enterprises. Since one of its key purposes was to determine the extent to which the various trade or investment-distorting advantages that may be granted by governments are inherent to SOEs, the survey included questions on both private and state-owned entities (See also Kowalski and Perepechay, 2015).

A majority of surveyed firms indicated a belief that their competitors benefit from preferential treatment granted by foreign governments; this belief was much less widespread regarding domestic governments. Potentially this illustrates the greater difficulty of minimising state enterprise-related distortions in an international context. Ownership status of firms was perceived to matter; the reported severity of the impact of preferential treatment of enterprises by governments was higher for SOEs (Figure 1.8).

Figure 1.8. **Which types of enterprises receive preferential treatment* by foreign governments, with the largest impact on your sales?**



**Preferential treatment* is defined as government measures or actions, which affect costs or prices of commercial enterprises and which are extended only to certain specific enterprises or groups of enterprises.
Own government is defined as the government of respondent's country of headquarters.

Source: OECD Business Survey on State Influence on Competition in International Markets.

Financial and regulatory support granted to both private and state enterprises were the most often indicated concerns although the reported market effects were stronger for state firms (Figure 1.9). Likely reflecting the deepening of international commercial links and increasing geographical fragmentation of production, the economic effects of preferential treatment of state enterprises by foreign governments were reported to extend beyond foreign markets, affecting domestic sales of respondent companies almost to the same extent.

Figure 1.9. **Which forms of preferential treatment granted to privately-owned and state-owned enterprises have the most harmful impact on your sales?**

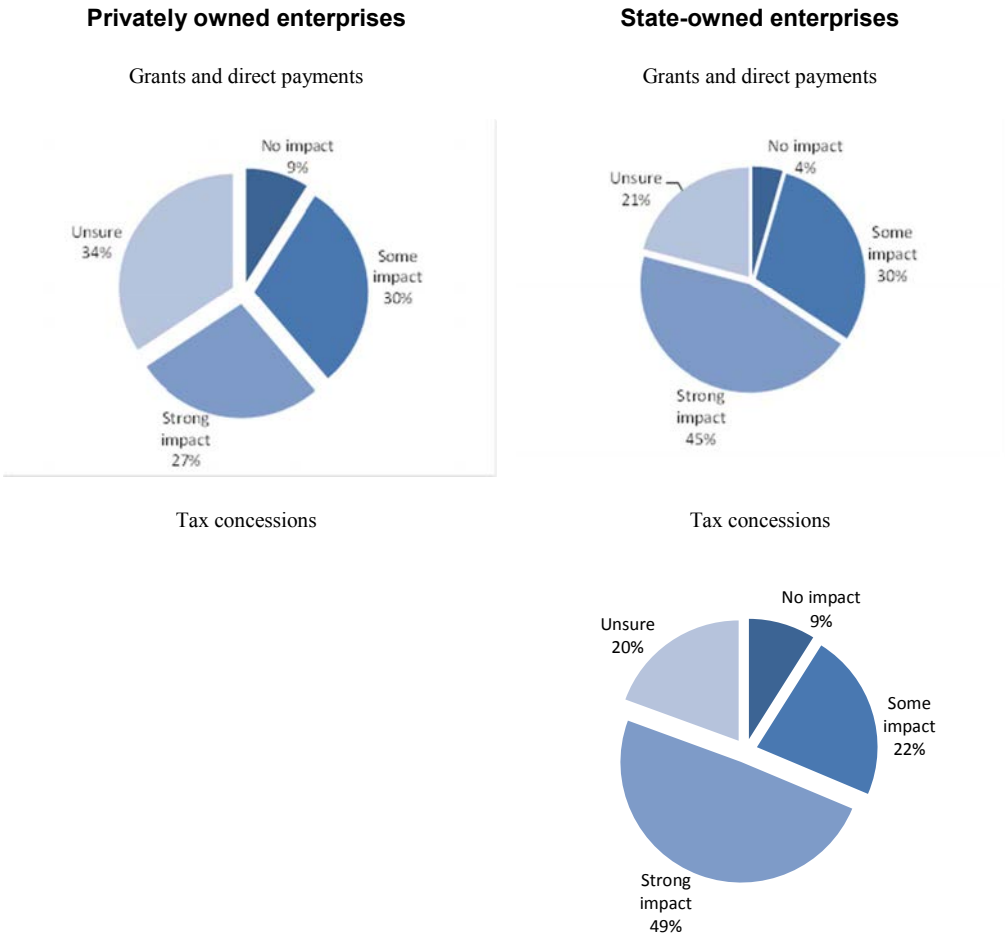
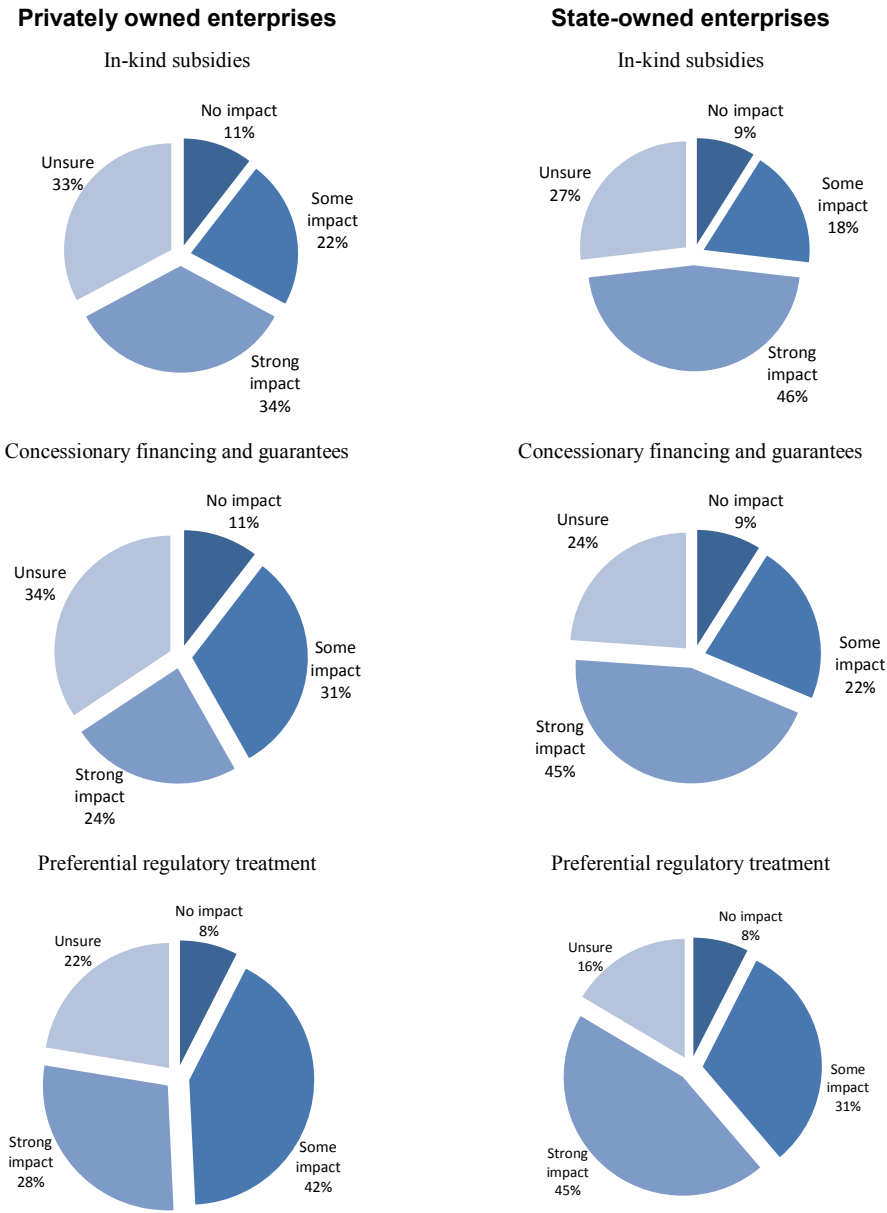


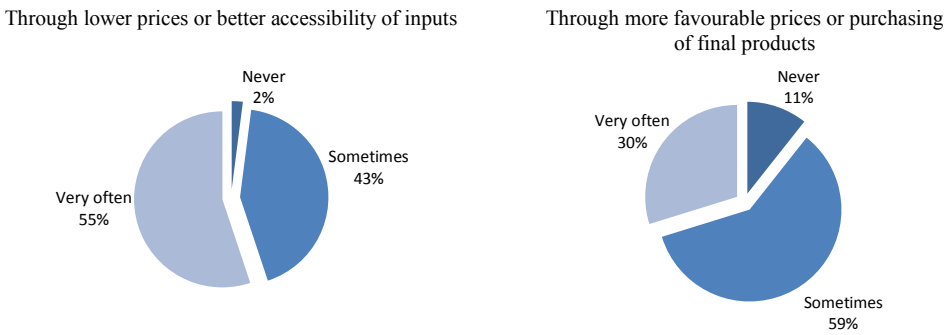
Figure 1.9. **Which forms of preferential treatment granted to privately-owned and state-owned enterprises have the most harmful impact on your sales?** *(cont.)*



Source: OECD Business Survey on State Influence on Competition in International Markets.

Many firms reported the use of state enterprises by governments to indirectly grant advantages to respondents' competitors through lower prices or better accessibility of inputs (Figure 1.10). Central or federal levels of government were reported to be granting advantages with strong negative impact on competition more frequently than sub-federal governments, though the latter were engaging in discriminatory behaviour as well. Based on academic literature describing the internationalisation of SOEs one would assume that some of the "advantages" reported by competitors relate to concessionary treatment by development banks and export credit and/or investment insurance agencies involved in project financing abroad.

Figure 1.10. **How prevalent is the use of state-owned enterprises by foreign governments to indirectly grant advantages to your competitors? (all firms)**



Source: OECD Business Survey on State Influence on Competition in International Markets, OECD (2015).

c) The perspectives of the steel sector[11]

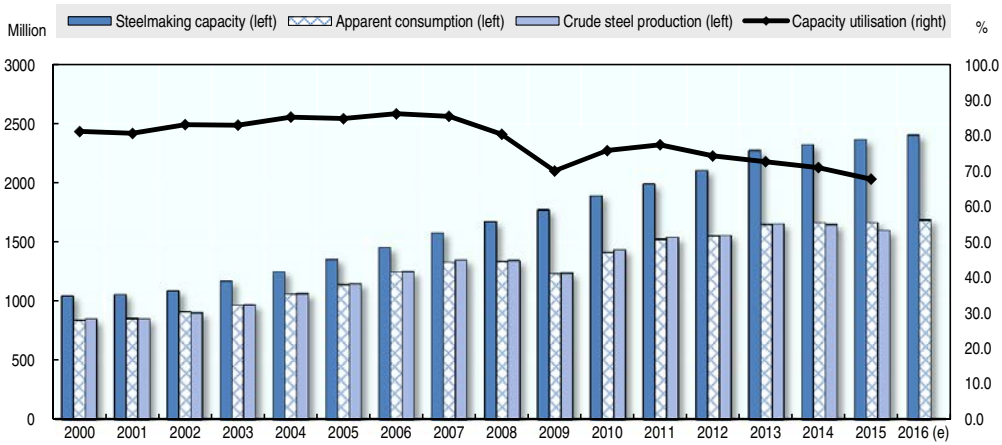
A sector where many of these concerns have been felt in recent years is in the steel sector where SOEs (especially in emerging markets) are some of the main players and where issues of "undue advantages" related to state support has come up. The concern with the growing role of SOEs in the global steel sector relates to the extent to which their investment decisions are market-based and how they are contributing to excess capacity which is illustrated in a number of trade, investment and competition challenges discussed in the following sections.

Excess capacity is the biggest challenge facing the global steel industry today. According to the OECD's latest coverage of steel market developments (OECD, 2016a), the global steel industry's capacity to produce steel has more than doubled since the start of the current century, from a level of 1.06 billion tonnes in 2000 to more than 2.3 billion tonnes

in 2015. [12] Although global steel demand kept up with the pace of capacity growth until the first half of 2008, the eight years since the start of the global financial and economic crisis have been characterised by a sharp slowdown in world steel demand, particularly as China's steel demand growth moderates to a lower pace commensurate with the rebalancing of its economy towards the so-called "New Normal".

Over the course of 2015, the outlook for the steel industry has weakened even further, resulting in stagnation of crude steel consumption and production due to negative market sentiment in steel-consuming economies. While, steel demand growth (apparent steel use) has come to a halt in 2015, production fell by 2.9% in 2015 (y-o-y) following a decline of 0.2% in 2014. The production slowdown has been broad-based, affecting almost all regions of the world. In many economies, local producers are adjusting output in response to heightened import competition. The gap between growing capacity and stagnant consumption continues to increase, leading to lower capacity utilisation rates that may have important implications for the sustainability of the industry (Figure 1.11).

Figure 1.11. **World steelmaking capacity - Demand imbalances**



1. Data refers to crude steel. Capacity is defined as nominal crude steelmaking capacity. Capacity utilisation is calculated as crude steel production divided by nominal crude steelmaking capacity

Source: World Steel Association and OECD.

Despite this outlook, many investment projects, aimed at expanding steel production capacity, continue to take place in many parts of the world, which has led to a significant increase in the level of global excess capacity

(the difference between nominal steelmaking capacity and demand). Excess capacity has surged from a level of around 250 million tonnes in 2006 to a level estimated at more than 700 million tonnes in 2015. Moreover, recent data on investment intentions combined with a weaker outlook for steel demand suggest that excess capacity might increase further in the near term. More specifically, new steelmaking capacity investment projects are being planned in some Asian economies and, to a lesser extent, in the Middle East and North Africa region.

In the steel industry, periods of significant excess capacity are often associated with oversupply that results in trade disturbances and, ultimately, escalating trade policy actions to protect domestic producers. As industry profitability deteriorates, some governments tend to resort to beggar-thy-neighbour policies and other measures that push the burden of industry adjustment to trading partners. Notoriously high exit barriers, and, importantly, government interventions to preserve capacity during market downturns because of the important and strategic nature of the industry mean that market downturns can often turn into steel "crises". For example the current crisis has led to an increase in the number of steel plant closures, a trend that is expected to intensify in the near future as a result of the weak demand outlook and challenging market conditions (resulting in social and human costs). Structural adjustment will be needed to ensure the economic viability of the global steel industry and help reduce trade frictions amongst trading partners. Many such steel crises have been experienced over the past several decades, and the consequences have proven to be painful and long-lasting.

The issue at hand is the following. In competitive economies, it is the responsibility of the steel companies themselves to identify ways to adapt to changing market conditions. That is, businesses are best placed to decide on when to invest in new capacity or when to scale it back when market conditions change. The role of governments should be to let market mechanisms work properly and avoid measures that artificially contribute to global excess capacity. The concern with the growing role of SOEs in the global steel sector relates to the extent to which their investment decisions are market-based and how they are contributing to excess capacity. In the steel sector today, investments are often part of national development strategies for the steel industry, for example to attain self-sufficiency in steel production and thus reduce that country's dependence on imported steel. Accordingly, such strategic objectives often result in policies that encourage steelmaking capacity expansions. Anecdotal evidence suggests that some of these investments are carried out by SOEs. In addition, national governments also try to attract foreign, technologically advanced

steelmakers to partake in joint ventures with SOEs, to encourage technology transfer and to build the knowledge base for the domestic industry.

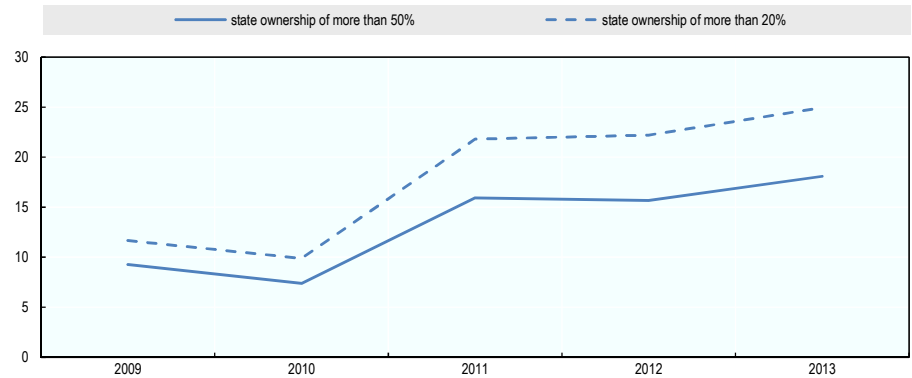
However, notable is also the role that state involvement may have in promoting efficient industry restructuring. For example, state ownership played an important role in helping the restructuring process of the steel industry in some European countries, notably in France and in the United Kingdom, with the view towards privatisation once their steel industries became more viable. In the United Kingdom, 14 distressed UK steel companies were nationalised to form the British Steel Corporation (BSC) in the late 1960s, to facilitate restructuring of the industry. BSC adopted important measures to modernise, rationalise investment, and improve cost efficiency. The process led the British steel industry from significant losses to profitability in the 1980s and successful privatisation in 1988 (OECD, 2012b). In France, Usinor and Sacilor were nationalised in 1981 and the two were merged in 1986. State-owned Usinor-Sacilor reduced its workforce in core steelmaking, rolling and processing activities by 60% between 1984 and 1994. Profitable by 1994, the company was privatised in 1995. The process of restructuring and privatisation in Europe during the 1980s and 1990s led to a more efficient and competitive industry by the turn of the century. Recent work by the OECD Steel Committee has focussed on understanding the prevalence, scope and general trends of state enterprises in the steel sector. Some of the findings of this work are summarised below.

SOEs in global steel production. State-owned enterprises play an important role in the steel industry, notably in several emerging economies. SOE production shares have been increasing in the most recent years. Recent data taken from the 40 largest steel producers in the world indicate that state-owned enterprises (defined as the state owning more than 20% of the company) accounted for around one-fourth of the sample's total production in 2013 (Figure 1.12). Using the 50% ownership threshold suggests a production share of less than one-fifth. Within the list of the largest steel producers in the world, SOEs are most prevalent in China, though India and Iran also have some large companies with state ownership exceeding 50% (OECD, 2012b).

Role of SOEs in new steel investment projects. In order to better assess the future evolution of steelmaking capacity, the OECD has developed a database of all future crude steel investment projects in the global steel industry (that is, those that are planned or underway), using publicly available information. This database is currently available to the public.[13] The data suggest that approximately 40 steelmaking investment projects are being carried out by state-owned firms (Table 1.2). Table 1.2 does not include joint ventures between state-owned and private companies or other state-private initiatives; it lists only SOE-based investments that are

underway or planned either by domestic or foreign state-owned companies in the economies listed in the table. The total capacity addition associated with these SOE investments is almost 124 million tonnes, representing slightly more than one-third of the capacity addition of all proposed future investment projects.

Figure 1.12. **SOE share in the total crude steel production of the world's largest 40 companies**



Source: OECD (2015p).

As in other sectors, there are complex ownership links and the potential for preferential treatment of SOEs. For example, recent work conducted by the OECD Steel Secretariat suggests that SOEs sometimes receive financing for their projects from different government-related financial institutions (OECD, 2015p). Initial work examining government-related financing of 17 proposed steel investment projects showed that seven of those projects were by SOEs.

State-owned enterprises in steel are also actively investing abroad and in both steelmaking facilities and upstream sectors. While OECD (2015o) shows that in 2014 many steelmaking capacity investment projects by SOEs are underway or being planned overseas, OECD (2012b) shows that SOEs were among the most active foreign investors in steelmaking raw materials between 2007 and 2010.

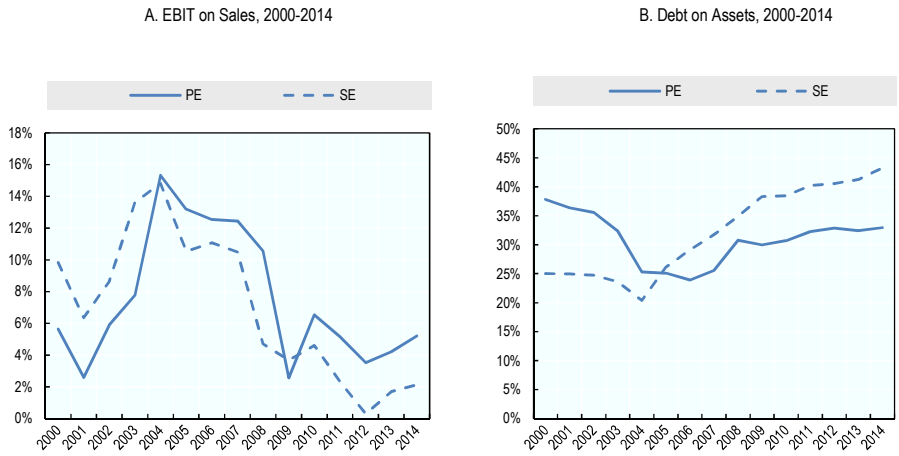
Table 1.2. **Location and capacity of SOE crude steel investment projects around the world**

Region	Destination of SOE investment (can be domestic or foreign SOE)	Number of Projects	Approximate Capacity Addition (thousands of tonnes)
Africa	Algeria	1	5 000
Africa	South Africa	1	5 000
Africa	Nigeria	1	4300
Africa	Egypt	1	1800
Africa	Libya	1	1300
Africa	Tunisia	1	400
Africa	Ethiopia	1	300
Asia	China	10	51018
Asia	India	6	23900
Asia	Indonesia	1	5 000
Asia	Malaysia	1	3500
Asia	Mongolia	1	3500
Asia	Vietnam	1	500
CIS	Azerbaijan	1	Unknown
Latin America	Venezuela	1	1550
Latin America	Bolivia	1	150
Middle East	Iran	5	7550
Middle East	Oman	1	3 000
Middle East	Saudi Arabia	1	3 000
Middle East	United Arab Emirates	1	2300
Middle East	Iraq	2	670
Total		**40**	**123 738**

Source: OECD investment project database, available at: www.oecd.org/sti/ind/steelcapacity.htm and OECD (2015o).

The financial performance of SOEs in steel. Preliminary results of an analysis of the financial performance of more than 600 publicly traded steeflmaking companies between 2000 and 2014 suggests that SOEs have been less profitable and more indebted over the last ten years, on average (Figure 1.13).[14] While SOEs accounted for only 3.6% of the sample, their share of total sales was 17.7%. In other words, in the steel sector, SOEs appear to be much larger than private enterprises, on average.

Figure 1.13. **Financial indicators for steelmaking SOEs**



Note: The solid lines provide information on the trend for private enterprises (POEs), while the dashed lines provide information on state-owned enterprises (SOEs).
Source: OECD calculations based on data from Factset.

Chapter 2

International investment and state-owned enterprises[15]

Cross-border investment by state-owned enterprises (SOEs) is not a new phenomenon. It has a long history, but its acceleration in recent years – as well as the growing involvement of emerging economies as actors on this stage – has nonetheless begun to generate some policy debate and uncertainty among host countries for these investments. This chapter provides some stylised facts on international merger and acquisition (M&A) activity, exploring the prevalence of SOEs as acquirers or targets, and the sectorial composition and key attributes of deals involving SOEs. It attempts to sort "fact from fiction" regarding the investment effects of SOE internationalisation and the corresponding concerns. The chapter explores domestic policy frameworks, international treaty practice and OECD instruments designed to deal with cross-border SOE investments. It points to the fact that most investment policies, until now, have not addressed the sources of undue advantage for SOEs.

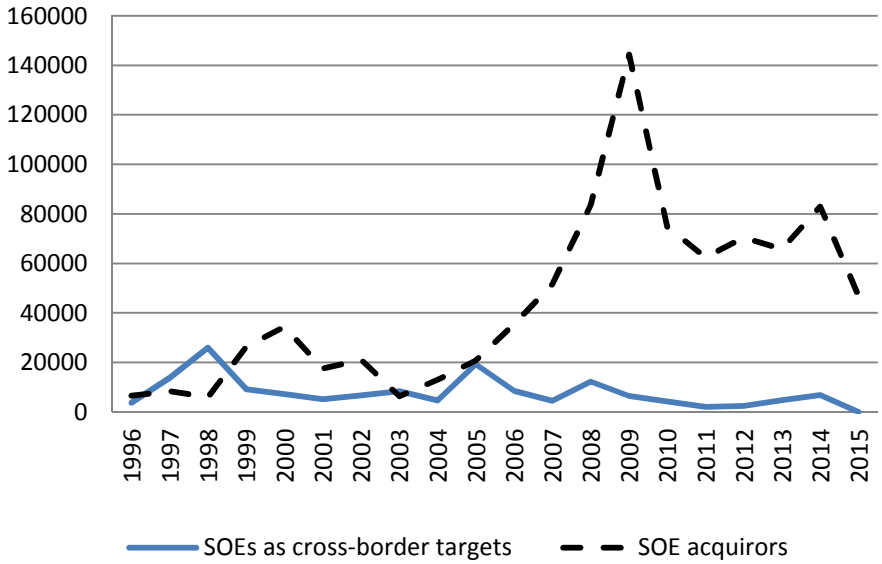
2.1. SOEs in international investment: Stylised facts

International investment by SOEs and other enterprises consists basically of two types of transactions, namely mergers and acquisitions (M&A) involving the assets of existent companies and greenfield investment in new establishments. OECD collects such data on foreign direct investment (FDI), but they allow no distinction between SOEs and other investors. Also, in accordance with balance of payment statistical conventions they include reinvested earnings and loans between related enterprises into FDI, which is unhelpful from the perspective of the present report.

International M&A data is used below to help grasp how firm investment decisions and strategies differ between private firms and SOEs when these operate abroad. Most of the empirics referred to below are based on a study conducted for the OECD in 2014, drawing on a dataset of 206 140 M&A deals (USD 49.7 trillion in total value) over 1996-2013. (Importantly, in the context of this study only company which were fully owned by the state were counted as SOEs.) This is a useful point of departure, as one of the characteristics of past FDI booms has been an increase in the share of IM&A in FDI. Though M&As by SOEs represent only a small portion of total M&A activity (7% in 2013), this share has vastly risen since 1996 (when it stood at 0.9%). International M&A (IM&A) makes up about 30% of all M&A activity today, and is more balanced between developing and emerging economies.

Figure 2.1 provides an overview of wholly-state owned enterprises' involvement in IM&As over the last 20 years. The value of SOEs' outward investment spiked at the outset of the current financial crisis (the years 2008-10), which has been attributed by earlier studies to the fact that SOEs, being less dependent on market financing for their transactions (as discussed further below), were relatively less affected by the crisis and benefited from the weakening of their competitors to acquire corporate assets abroad. Conversely SOEs seem to be targets of very few IM&A deals compared to the amount of acquisitions they make internationally. At first glance this could be seen to indicate a lack of contestability in SOE home markets. However, it must be kept in mind that the acquisition of (parts of) a wholly state-owned SOEs effectively amounts to privatisation by the host country government. Privatisations have certainly occurred during the period under review, but they are rarely targeted at foreign investors[16]. Indeed, when only domestic M&A is considered, data indicate that SOEs do remain targets for domestic buyers.

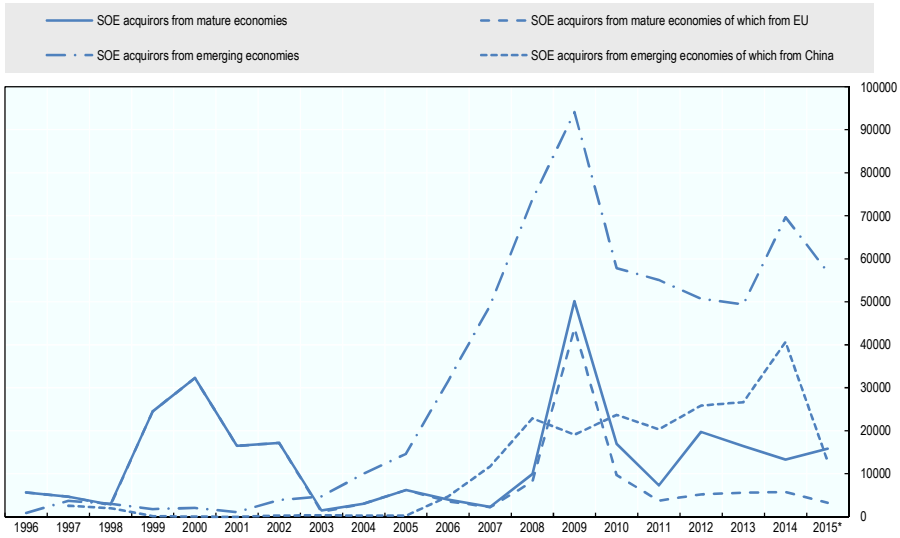
Figure 2.1. **SOEs as targets and acquirers of IM&A by deal value (USD million), 1996 - 2015**



Source: Author calculations based on Dealogics IM&A data, 2015.

Figure 2.2 provides an illustration of the trends in countries of origin of IM&As over the last two decades. Among the "mature economies" (whose SOE investment originates largely, but not exclusively, in the European Union) there is no clear trend. Two peaks at the time of the "dot com bubble" in 1999-2000 and the onset of the financial crisis in 2008-9 could be taken to indicate that home country authorities at those times had to acquire certain corporate assets from troubled private firms. Conversely, the trend among emerging economies is clearly upward. Press reports often attribute this to the rise of Chinese SOEs, but while the Chinese importance had definitely grown (and is now at part with the total from all mature economies, it has mostly been below the IM&As that emerge from the large number of other emerging economies.

Figure 2.2. **SOEs as targets and acquirers of IM&A by deal value (USD million), 1996 - 2015**



Source: Author calculations based on Dealogics IM&A data, 2015.

2.2. Concerns related to internationalisation of SOEs from an investment perspective

As illustrated above cross-border investment by state-owned Enterprises (SOEs) is not a new phenomenon. It has a long history, but its acceleration in recent years – as well as the growing involvement of emerging economies as actors on this stage – has nonetheless begun to generate some policy debate and uncertainty among host countries for these investments. For the most part, the perceptions and concerns regarding the international dimension of SOE investment remain unclearly formulated or nebulous, sometimes pertaining less to the state-owned dimension of the investments than simply to their foreignness; and not all of these concerns are fully justified. Especially in the media coverage of this topic, there is moreover a prominent focus on Chinese state-owned investment, which is only one part of the story. Sections 1 and 2 below provide a typology of the main concerns that have been tied to the internationalisation of state-owned investment. As discussed in the introductory section these fall into two overarching categories:

- SOEs may benefit from 'undue advantages' which are unavailable to private firms and which might place the latter on an unequal footing in

cross-border investments. These advantages can have a first-order effect on 'crowding out' of potential private investors, whether foreign or domestic. This chapter thus considers the potential for preferential financing, foreign state immunity, and protected home market revenues, for cross-border SOE investors.

- More basically, SOEs may be tasked by their government ownership with "policy objectives" other than maximising profits and long-term value. These may specifically relate to the SOEs' role abroad or, perhaps more commonly, be designed to suit the domestic community of the SOEs but have inadvertent effects when the enterprises internationalise. To the extent that these differ from any "non-commercial" activities that private firms might also pursue, they might further 'tilt' the international investment playing field, and elicit varying investment policy responses from host country governments. In this vein, Section 2 investigates how SOE behaviour might raise concerns of espionage, critical infrastructure control or sabotage, natural resource control or market cornering, systemic risk, and differences in responsible business conduct.

Within each category, this chapter attempts to sort "fact from fiction" regarding the investment effects of SOE internationalisation, and the corresponding concerns. The chapter then highlights some of the policy responses available from an investment perspective, at domestic and international levels. However, before addressing these overriding issues, it is worth reminding that some of the motivations for internationalising SOEs may defy the two overriding categories (below).

Alternative explanations for SOE behaviour and incentives overseas

Much analysis related to foreign investments by SOEs (as well as media coverage) assumes that the SOE and its home government are one and the same in terms of their strategic motivations for investment. But further political economy analysis points to principal-agency gaps between the government and the firm, and between the SOE's headquarters and its foreign subsidiaries. Rather than considering the SOE and its home country as a monolithic bloc, several analysts for instance posit that overseas expansion might be motivated by SOEs trying to avoid being squeezed dry by their home government (particularly if resources at home are constrained). Choudhury and Khanna (2014) find evidence for this with a sample of Indian firms. The primary motivations for some SOES to invest overseas may thus be to gain more resource independence from other state actors at home – with any motivations related to host country resources and markets coming only as a secondary consideration.

Another key motivation for SOEs investing overseas, which is often overlooked and not systematically linked to the home government's objectives, is economic self-development. Taking the case of China, Hongtu (2015) argues that for many SOEs, international exploration and production are a means of improving the technological, technical and managerial capabilities of companies and facilitating the export of related facilities, technology and labour. Especially for local SOEs, company interests do not always accord with those of the government and are sometimes in direct conflict with them; overseas commitment decisions are independently made, based on their evaluation of the risks and returns. In the energy sector for instance, Hongtu explains that SOE investments are not necessarily connected with a domestic energy shortage. Rather, such perceptions result from a "general lack of knowledge [both within China and abroad] on how Chinese SOEs do business overseas and the nature of their relationship with the central government". Hongtu argues that SOEs in the sector are primarily driven by profit motives and competitive pressure.

Chinese SOEs covered in a 2014 OECD survey tend to agree, identifying the following as their main motivations for overseas expansion: better allocating resources globally; acquiring advanced technologies and management experience; and integrating the company's product line and catering for the Chinese domestic market. They claim to have no explicit financial targets, to access financing mostly through internal resources, and to have little involvement from their headquarters in day-to-day operations (Kowalski, P. and K. Perepechay, 2015). Likewise a 2014 survey of Chinese SOEs, commissioned by the Business Council of Australia, highlights seven motivating factors for SOEs in Australia: global profit seeking; consumer market reach; following Chinese migrants; local integration (notably for subsidiaries in the banking sector); strategic expansion; enabling tourism growth; and brand acquisition (KPMG, 2014). All of these stretch beyond merely securing strategic resource supplies or serving foreign policy objectives.

Another often ignored motivation for SOE expansion could be "legitimacy building". When state ownership creates "hostility" in the host economy, according to Cuervo-Cazurra et al (2014), SOEs will tend to increase investment spill-overs in the host economy to compensate, including by engaging in more "legitimacy building actions" (such as RBC efforts). For the same reasons SOEs may also prefer green-field operations, or take lower equity stakes in the subsidiaries they are acquiring, to avoid controversy and to rather create new productive facilities.

Possible sources of 'undue' advantages for SOEs compared to private firms?

i) Preferential financing? Acquisition price and financing modalities

The source of undue advantages for multi-national state-owned enterprises (MNSOEs) that is perhaps most frequently mentioned by international observers is financial support from the home government. Some of this support is direct, in the form of concessionary finance, or of investment subsidies. Some of it is indirect, such as implicit, or perceived, government guarantees which can allow cheaper access even to international financing. Overall, this represents a largely undisputed source of advantages for SOEs which one OECD country (Australia) has even developed mechanisms to neutralise[17]. Other things equal this provides SOEs with an operational advantage in their domestic as well as cross-border operations[18]. The extent that such advantages also influence individual investment decisions and modalities of internationally operating SOEs and other companies is less evident, but IM&A data may shed useful insights.

On average, one might first of all expect SOEs to offer higher prices than other companies for target companies in IM&A, if they benefit from preferential financing (whether direct or indirect). Indeed if the SOE acquirer has a lower cost of capital than other acquirers, it can attribute a higher present value to future free cash flow because of a lower discount rate. The modality of payment, or the financing choices of SOEs versus private firms in their IM&A, can also provide some insights. As detailed in earlier work (OECD, 2014e), the 'pecking-order' model of financing hierarchy posits that among their three available options for financing international investments (assets, including cash; debt; and equity), investors will always prefer assets, including cash – as these are generally cheaper, and control of the acquiring entity is least diluted. Equity, being the most expensive source of financing, would only be used as a last resort. Internationally, private equity thus accounted for 21% of total gross cross-border M&As in 2013, 10 percentage points lower than at its peak in 2007; and this share has declined by a further 11% in 2014, to reach USD 171 billion (UNCTAD, 2014).

If their capital costs are relatively lower than they are for private firms, SOEs might therefore be expected to place higher in the 'pecking order' of IM&A financing. Indeed as firms move from cash, to debt, and to equity in order to finance their new investments, they are revealing relatively tighter capital constraints (Lehmann and Tavares-Lehmann, 2014). IM&A analysis confirms this picture: SOEs tend to use a much higher proportion of cash and internal funds to finance their deals. They employ less debt, and (mostly in consequence of their state ownership) far less equity, than other

companies, even when controlling for the size of the deal, and regardless of whether the deal is in the financial sector or not. In fact, on average 88% of the SOE deals studied were closed with "cash only" (up to 97% of all deals in 2002), compared to only 77% for other deals. Furthermore within the full sample, only 30 deals with SOE acquirers used "shares only", private firms accounting for 99.8% of this more constraining form of payment (Lehmann and Tavares-Lehmann, 2014).

ii) Political clout and foreign state immunity

The increase in cross-border SOE investments in recent years also brings into question the status of sovereign investors for the purposes of host country law enforcement. Indeed in some cases, government ownership may make it difficult for private parties to pursue legitimate claims against foreign SOEs and may create gaps in terms of regulatory enforcement (OECD, 2009 and 2010b). This could be a second source of advantage for SOEs as opposed to private firms when investing abroad. Because of this "foreign sovereign (or state) immunity", foreign government controlled investors (GCIs, which encompass SOEs) may not be subject to the full force of any legal system in the host country. For the business partners of these firms and for the investors themselves, this may entail legal expenses to manage the resulting uncertainties. If sovereign immunity effectively insulates foreign sovereign investors from the full force of recipient country laws while depriving others of protections that would otherwise be due to them, it could create competitive disadvantages for private (foreign as well as domestic) investors. Nevertheless as discussed below, the situation is more nuanced in practice.

In cases of absolute sovereign immunity, a country faced with alleged wrong-doing by a foreign GCI would have diplomatic, but few legal, tools for dealing with the situation. In several legal systems, sovereign immunity can even include "immunity from enforcement": the enforcement of an unfavourable judgement can be prevented even after jurisdiction was allowed and a court or other dispute settlement forum took a decision. However in recent years, as documented by the OECD (Freedom of Investment Roundtable), there has been a trend away from absolute immunity of foreign GCIs (OECD, 2009). Some jurisdictions have established an exception to sovereign immunity which applies when a foreign government is involved in "commercial activities" (or acts in the same way as a private person, in relations normally governed by "private law").[19] As far as regulatory enforcement goes, key factors include the nature of remedies to be applied (whether they are compensatory or punitive in nature); the public or private nature of the enforcement agency; and the

applicable definition of the foreign state and type of foreign state entity at issue (OECD, 2010b).

OECD and non-OECD countries have contributed to this trend toward commercial restrictions for sovereign immunity, by ratifying the United Nations or European Union Conventions, or by codifying a commercial exception to sovereign immunity through jurisprudence (see Section 2 below). This entails that even when a foreign GCI is involved, most commercial issues and some other issues (for example business crime related to commercial activities) can be explored and resolved by recipient country courts. This allows business to take place with foreign GCIs, including SOEs, in an orderly manner. In terms of legal accountability, it removes one possible source of undue advantage for internationally operating SOEs. The commercial activities exception to sovereign immunity also provides more legal protection to business partners of the foreign GCI in the host country (OECD, 2009).

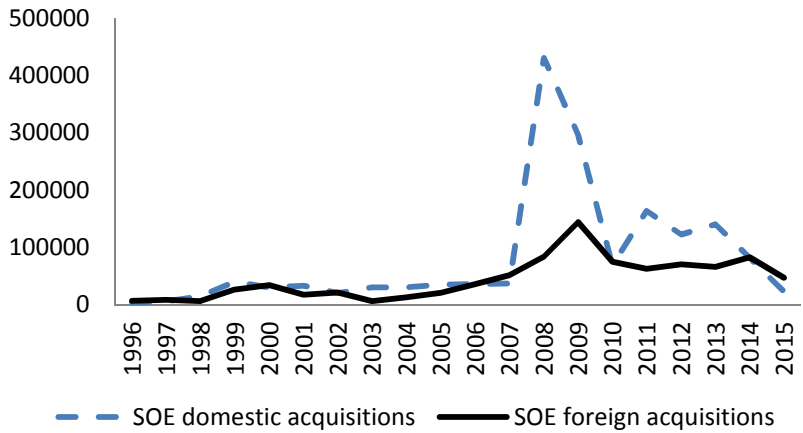
iii) Home base, home bias, or both?

The existence of a protected source of revenue back home is a third potential advantage for MNSOEs as opposed to private firms in their international investments. This can allow for potential cross-subsidisation of overseas investments, and /or more risk-taking in international operations than equivalent other companies. The less, companies have to worry about maintaining a competitive footing and avoiding takeovers in their home base, the more resources and efforts can be concentrated on overseas investments.

Alongside this picture of relatively protected SOE status in home markets, there is evidence of sustained home bias (or the greater propensity to undertake domestic rather than international M&A deals) for SOEs and private firms alike. In the overall corporate sector, domestic deals stand at 75.7% of all M&A deals by number in 2013 (only slightly down from 77.5% in 1996) and at 71.9% by value of deals (compared to 82.8% in 1996, as average deal size has decreased over time). As for SOEs, in 2013 they conducted about 2.5 times more deals domestically than abroad, and the average size of their deals increased from USD 203 to 537 million between 1996 and 2013. Figure 2.3 illustrates that cross-border investment by SOEs therefore remains a small share of their overall portfolio (3.8% of the total number of deals and 8.1% of the total deal volume). Figure 2.4 further shows that although the share of SOE activity in total international M&A is historically a bit higher than the SOE share in total domestic M&A, the two track each-other very closely. Like other companies therefore, SOEs continue to covet their home base – with good reason. By illustrating how relevant the domestic picture remains for the operations of MNSOEs, this

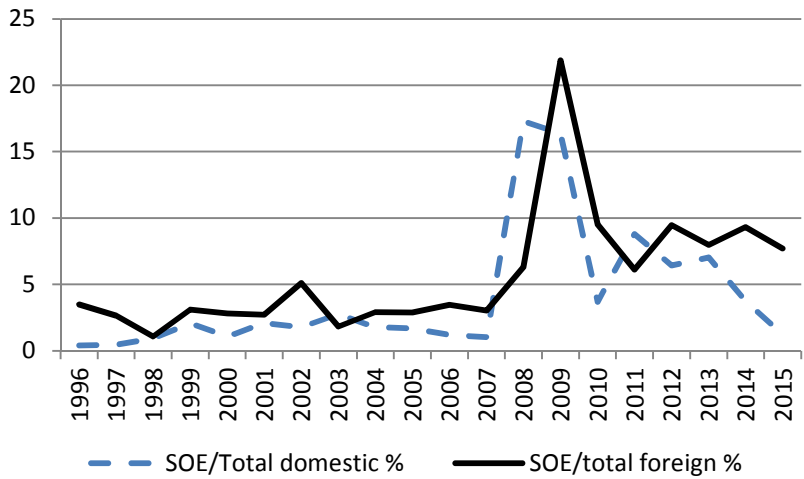
result moreover flags the importance for policy makers to address MNSOE behaviour not only in bilateral and international investment policy frameworks, but also within their domestic policy settings.

Figure 2.3. **SOE domestic vs. foreign acquisitions by deal value ($million), 1996 - 2015**



Source: Author calculations based on Dealogic data (2015).

Figure 2.4. **International and domestic share of SOE deals (percent) 1996 - 2015**



Source: Author calculations based on Dealogics IM&A data, 2015.

The brief analysis from Section 1 above nuances claims that MNSOEs might benefit from undue advantages when compared to privately owned MNEs. On the financing side, they do not pay higher premiums in their acquisitions, and although their payment modalities appear to reflect lower financial constraints, the picture is less clear-cut when one considers the effective interest rates of firms that are not 100% government-owned. Moreover such analysis must keep in mind that many large private MNEs can also benefit from privileged financing, especially implicitly (for instance greater willingness of banks to lend to large private MNEs and their affiliates, when compared to firms that are smaller or lack an equivalent global footprint). More micro-level and lending data would be needed in order to accurately assess to what extent SOEs really do put private MNEs at a competitive disadvantage on the financing front.

As regards foreign state immunity, exemptions for commercial activities are on the rise and may increasingly limit the extent to which foreign government ownership can be wielded as a bargaining chip, or as a pretext for MNSOE non-compliance with host country regulations. And as for their home base, MNSOEs seem to indeed enjoy a protected status vis-à-vis foreign acquisition; though domestic acquisition remains a real possibility, and overall domestic deals continue to dominate both private and SOE M&A activity.

Due to the relatively recent nature of large-scale cross-border SOE investment, the extent to which these different sources of undue advantage result in investor crowding out in practice (i.e. in different markets) is difficult to measure. To date empirical work on crowding out has mainly been limited to the effects of FDI in general (whether public or private; see for instance Romer, 1993; Agosin and Mayer, 2000), or of SOE investment in a purely domestic context (Bueler and Wey, 2013). Investigations into the crowding out effects of SOE FDI remain a gap in the literature. Future work could for instance usefully consider changes in market shares in various countries and industries, before and after large MNSOE investments.

How might SOE and other firms' behaviour and incentives differ when investing abroad?

Past OECD work has investigated which risks should be factored into national security-related investment policy analysis of foreign government-controlled investors (OECD, 2009). Many of these risks touch on how SOE investment behaviour and/or incentives might differ from those of other companies, both pre- and post-establishment. In their majority, these concerns relate to SOE behaviour following "non-commercial" objectives, which might threaten the national security or other vital interests of the host

country – especially if SOE investment reveals itself to be a so-called "Trojan horse", or a conduit of foreign policy objectives.

Whereas the undue advantages identified in Section 1 relate more to inter-firm competition, concerns related to non-commercial behaviour by SOEs are therefore more geopolitical in nature. This said, these concerns are still rather infrequently raised in the media, and the reactions in terms of host country investment policy have generally remained moderate as well. As this section illustrates, often policy responses that have been justified for reasons of national security or competitive neutrality in fact pertain more to foreign ownership in general, than to *public* foreign ownership in particular.

Another caveat to keep in mind in this section is that these concerns will have varying importance and relevance for different host countries – for instance developed or OECD economies might be more wary of intellectual property theft, whereas in developing host countries SOE investment in technologically advanced industries may in fact be a beneficial means of technology transfer. On the other hand, developing countries may be more concerned by the level of responsible business conduct of MNSOEs, especially if domestic capacity to deal with irresponsible business conduct by companies is weak. Host market size may also enter the equation, as small countries are likely to be more vulnerable to risks of service denial in critical infrastructure, or of loss of control over natural resources.

i) Critical infrastructure and sabotage risks

"Critical infrastructure" has received special attention in recent changes to national investment policies. Many countries have national plans or strategies for protecting critical infrastructure, which is generally defined as physical or intangible assets whose destruction or disruption would seriously undermine public safety, social order and the fulfilment of key government responsibilities. Sources of critical infrastructure risk could be natural (e.g. earthquakes or floods) or man-made (e.g. terrorism, sabotage). In the case of foreign ownership of the critical infrastructure service, sabotage and possible denial of services (should diplomatic relationships between home and host countries deteriorate) are among the more relevant fears. As per information provided by notifications made under the OECD National Treatment Instrument, as of 2008 all adhering countries had one or more investment measures that address infrastructure. These were generally of three types: (i) blanket restrictions; (ii) sectoral licensing or contracting; and (iii) trans-sectoral measures such as investment review procedures (OECD, 2008).

The relationship between Russia's state-owned Gazprom and Ukraine on the provision of gas illustrates that, whether as a trading partner or a host

country to foreign SOE investment, heavy economic dependency on provision of critical infrastructure by that SOE can backfire. The assumption that foreign SOEs are subject to greater political influence, and thus pose higher risks of infrastructure service denial, than foreign privately owned enterprises, is also illustrated by the Dubai Ports World (DPW) controversy. One of the more mediatised national security debates in this field, this broke out over the sale of port management businesses in six major U.S. seaports to the UAE state-owned company DPW. The six port management contracts had already been foreign-owned previously (by a private British company), but when the latter was taken over by the DPW in 2006 the question became politicised. Although the U.S. President approved the transaction, Congress overturned this approval by forcing the foreign investor to abandon the deal (CFR, 2008). The DPW case prompted Congress to pass the Foreign Investment and National Security Act of 2007 (FINSA, which clarifies that national security covers issues related to infrastructure).

But cases related to critical infrastructure do not just concern state-owned foreign investors: private companies can be targeted as well. For instance China's Huawei, despite being privately owned, has faced blockages in several of its proposed investments in both the Australian (2012) and U.S. broadband networks (2010, in a bid to supply mobile telecommunications equipment to Sprint Nextel Corp). In 2012, the Committee on Foreign Investment in the United States (CFIUS) further recommended that Huawei withdraw its application to acquire specific assets of 3Leaf, a U.S. server technology company (Carew and Wohl, 2011). The U.S. stance relative to Huawei was reported to the March 2013 OECD FOI Roundtable in the following terms (OECD, 2013a):

> "On 8 October 2012, the U.S. House of Representatives published the House Permanent Select Committee on Intelligence Investigative Report on the U.S. National Security Issues Posed by Chinese Telecommunications Companies Huawei and ZTE. The report suggests that "*China has the means, opportunity, and motive to use telecommunications companies for malicious purposes*" and that "*Suggested 'mitigation measures' cannot fully address the threat posed by Chinese telecommunications companies providing equipment and services to United States critical infrastructure*".
>
> The report concludes with recommendations that include that "Th*e United States should view with suspicion the continued penetration of the U.S. telecommunications market by Chinese telecommunications companies. CFIUS must block acquisitions, takeovers, or mergers involving Huawei and ZTE given the threat to U.S. national security interests. Legislative proposals seeking to expand CFIUS to include*

> *purchasing agreements should receive thorough consideration by relevant Congressional committees*."
>
> However the United States explained that the House Permanent Select Committee on Intelligence Investigative Report was drafted by an independent authority and reflects only the viewpoint of this individual committee. Although it included recommendations on CFIUS, it did not propose any changes to respective legislation, which has been unchanged since 2008. The report did not bind the United States to change its legislation regarding CFIUS in the future."

Where critical infrastructure is concerned, therefore, state ownership does not appear to have been the driving consideration for national security treatment by host countries to date. Foreignness seems to have been the more important factor, with private as well state-owned investments occasionally subjected to review. The following sections show that this also holds for other concerns related to "non-commercial" investor incentives (such as industrial espionage or market cornering): foreign SOEs and private companies alike have triggered national security responses in the past.

ii) Military and industrial espionage

As reflected by past investment policy decisions taken in the framework of national security/national interest screening and review mechanisms (see Section 3), the possibility that a foreign SOE could impair military or intelligence capabilities was a more present preoccupation of host countries several years back. Today these fears seem to be progressively replaced by concerns over strategic resources (detailed below), critical infrastructure and sabotage (as detailed above above), or, to a lesser degree, industrial espionage (acquisition of sensitive technologies, intellectual property theft, etc.) Nevertheless, risk of military espionage continues to be evoked in cases where the proposed investment is in close proximity to a defence or defence-related facility – as exemplified by the 2009 debate over possible acquisition of Australia's Prominent Hill mine by China Minmetals Corporation, regarding risks posed by the mine's proximity to the Woomera Missile Testing Range (Smith et al, 2012).

The Ralls Case provides another example of potential military espionage concerns, but in relation to a privately-owned company. In this case (although the decision does not explicitly refer to military espionage) the U.S. president ordered Ralls Corporation (privately owned by two Chinese executives with China-based Sany Group) to divest its interest in a windfarm project in the state of Oregon, because of its geographic proximity to a sensitive military airfield (Francis, 2014). This example can usefully be compared with a similar decision targeting another Chinese firm, this one

state-owned: following a review by CFIUS, Procon Mining and Tunnelling, Ltd., along with its affiliate, the Chinese SOE China National Machinery Industry Corporation, was to divest its entire investment in the Canada-based Lincoln Mining Corporation. Although details regarding the nature of CFIUS' national security concerns were not released, proximity of Lincoln's properties to U.S. military bases was taken to be a significant factor (Wiley Rein, 2013). This would suggest that private and state-owned investors are often treated the same way with regards to military espionage concerns – contrary to what recent media coverage may sometimes suggest.

Similarly, national security treatment with regards to industrial espionage does not seem to target SOEs more than other firms. Industrial espionage, if it takes place, risks undermining technological leadership in economically important sectors, or can facilitate illicit technology transfer. However, most charges to this effect in recent years have concerned private investors just as much as SOEs. Foreignness, rather than public or private ownership, again seems to be the more important differentiating factor. Thus in the field of cyber technology, China and France have both tried to develop their own Computer Operating Systems to ward off risks of espionage by large companies such as Apple, Microsoft and Google.

Considering IM&A data might help inform to which extent such 'non-commercial motivations' (whether they be espionage or other foreign policy motives) actually feature in the investment decisions of SOEs. As mentioned in Section 1, one would expect SOEs to offer higher prices than other firms on average, either: if they are less capital constrained and can therefore use lower discount rates to value the assets they acquire; or if strategic or political benefits from the acquisition (which do not appear in the market price) are monetised from the SOE's perspective. In the studied IM&A sample SOEs are indeed paying much more than others, to acquire smaller stakes in their targets on average. Lehmann and Tavares-Lehmann conclude that – unless they are systematically buying on average higher valued firms than private firms, which is unlikely – "SOEs are valuing their targets on average higher than privately-owned enterprises". In addition to possibly lower capital constraints, this might reflect "non-financial concerns that justify the higher valuation of the asset" (OECD, 2014e).

In other words, a valuation 'wedge' may exist for SOEs that might be explained by non-commercial motivations. SOEs may for instance be expected to overpay for foreign assets or to buy unprofitable target firms, for geopolitical reasons. Verifying this systematically would however require identifying the most flagrant cases of 'valuation mismatch' between SOEs and private firms in a given economic sector and country, and investigating each investment through a case-study approach. Indeed, unless investments are compared "like-for-like" in terms of sector and size, the overall

preference of SOEs to acquire bigger targets relative to other companies may distort the conclusions that can be drawn on firm valuation. These trends could indeed simply reflect more structural factors, such as: a systematic preference on the part of SOEs to go after larger targets (on average IM&A transactions by SOEs are indeed four times larger than those by private firms); or lower efficiency or competence of SOE managers, which has been one of the driving factors for privatisation in many OECD countries.

iii) Strategic resource control and market cornering

Should SOEs be deployed in the aim of acquiring strategic assets for the home country (energy security, rare earths, etc.), there is also fear of erosion of the strategic advantages of the host country, in particular loss of control over national resources. A related perceived threat, which is more competitive or commercial in nature, is that the very scale of inward SOE investment might result in 'cornering the market': the SOE could gain so much control of a particular commodity or service that it could become a price-maker in that market, despite not having *de jure* monopoly status. In extreme cases both of these situations can expose the local economy to downright 'political hold-up' should diplomatic relations with the home country deteriorate (for instance, risk of denial of essential service provision). These could be especially worrying possibilities for small developing countries where the MNSOE investment can have significant weight relative to the size and "bargaining power" of the domestic economy.

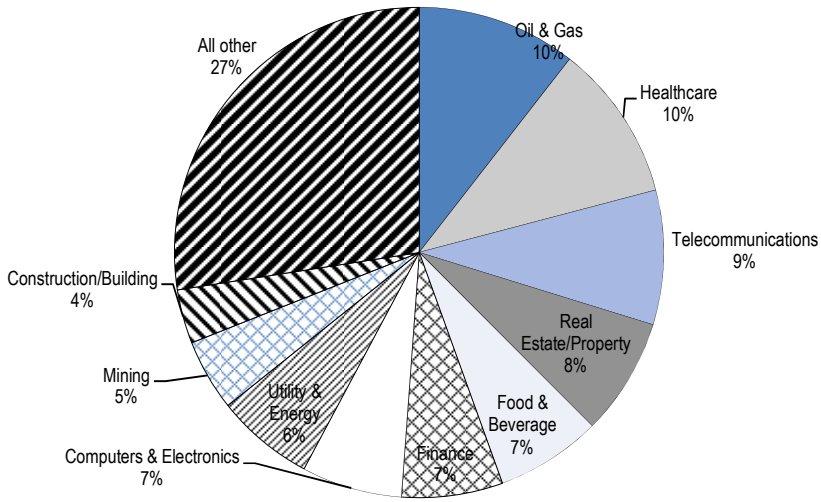
Larger economies have also felt threatened on this front. For instance in Canada, foreign investments in oil sands and energy have been subject to intense debate and SOE investments in the oil sands have been subject to policy changes (see also Section 2). Arguably in reaction to the rapid rise in foreign SOE investments it was receiving in the energy sector, in 2012 the Canadian government revised the Investment Canada Act to explicitly state that, "investors will be expected to address … in their plans and undertakings, the inherent characteristics of SOEs, specifically that they are susceptible to state influence" Entities that are "owned, controlled or influenced, directly or indirectly by a foreign government" must also assure the Ministry of Industry that the project is commercial and free from political influence (Bowman et al, 2014).

Wider public opinion and sentiment can also have an important bearing on national security treatment and perceptions. In Australia, the 2014 Lowy poll, the leading annual tracking survey on Australian foreign policy, concluded that 60% of Australians remained opposed to foreign investment in Australian agriculture, with particular opposition to Chinese investment. However the reasons for this (whether national security or other) are not

specified; nor is it clear whether this public sentiment is directed specifically at SOEs, or just at Chinese investors in general. Although they are of course inter-linked, the distinction between public concerns and central government concerns must therefore be carefully kept in mind when identifying and assessing prevalent perceptions of SOE investment in the global marketplace. Moreover in a current global context of sliding mineral and oil prices, the debate may progressively be switching more towards MNSOE investment in real estate and insurance, which arguably pose lesser national security concerns.

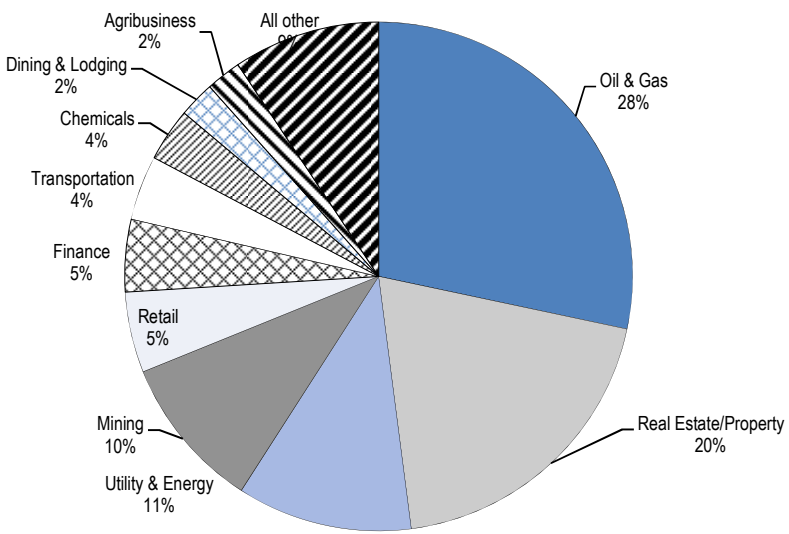
The premises of deliberate market cornering or strategic resource acquisition can only partially be checked against the available IM&A data. On the one hand, a different spread of investments by sector between internationally operating private firms and SOEs might point to different (possibly non-commercial) investment objectives between the two; on the other hand, it could simply reflect basic differences in the underlying sector propensity of the investors (for instance, since state ownership is relatively prevalent – even domestically – in utility sectors across the globe, it would not be surprising to see a higher concentration of SOE as compared to private activity in IM&A for the energy sector). Figures 2.5 and 2.6 below show that sector composition changes quite significantly depending on whether one looks at all cross-border deals, or at SOE-led deals alone. While the general picture for the past five years shows a relatively equal spread of investment across oil and gas, telecommunications, healthcare and real estate (which all are among the preferred target sectors for IM&A, and range from 8 to 10% of total deals by value), both oil and gas and real estate are far more present in SOE-led deals (28% and 20% of all deals, respectively) (OECD, 2014e). Energy and mining are also far more present on the MNSOE radar (each at 10%), especially as a result of European SOEs taking advantage of EU-mandated market liberalization. Meanwhile an earlier study indicated that SOEs from emerging markets have shown no equally visible upsurge (Christiansen, H. and Y. Kim, 2014).

Figure 2.5. **Sector breakdown by target of all cross-border M&A, 2011-2015 (by total value of deals, USD million)**



Source: Author calculations based on Dealogic data, 2015.

Figure 2.6. **Sector breakdown by target of SOE-led cross-border M&A, 2011-2015 (by total value of deals, USD million)**



Source: Author calculations based on Dealogic data, 2015.

Analysis for 1996-2013 indicates that these sectorial patterns also change between listed and non-listed SOEs. Over 70% of IM&A for listed SOEs over that period went into transportation and public utilities and manufacturing, whereas over half of IM&A for non-listed SOEs was in finance, insurance and real estate. The same pattern is also observed in the non-listed private firms: while these accounted for only a quarter of total IM&A in the sample, they covered 54% of deals in the finance sector (OECD, 2014e). These important differences flag that even when they share the same home country, SOEs vary greatly in their composition and in the institutional and financial pressures they face. Different listing requirements, levels of ownership or lines of financing can result in very different behavioural incentives and IM&A behaviour – independently of (and perhaps with greater impact than) any political or strategic pressure from the home government.

Overall and taking these nuances into account, IM&A data suggests that while SOE investments are becoming more international, they are not necessarily growing more political. Although the sectorial focus differs somewhat between SOEs and others, no clear conclusions can be made as to the political (or other) motivations of this investment. Data on stake size nevertheless paints a potentially more meaningful picture. Overall, SOEs take smaller stakes in target companies, in percentage terms, than private firms when investing internationally (although the size of the deal is bigger). Table 2.1 presents deal characteristics in terms of whether acquirers go for outright purchase (100%), majority interest (>50%), or partial interest (<50%). The favourite approach of private firms is thus to undertake outright purchases (32% of deals). In contrast, this is the least favoured option of SOEs (10%), while the majority of SOE deals are for a partial interest (53% of deals, versus 31% of deals for other companies). In fact generally, private firms acquire proportionally larger stakes than SOEs in both international and domestic M&A and irrespective of whether or not deals are in the financial sector. This runs counter to what one could expect if SOEs were predominantly motivated by foreign policy and resource control objectives – as lower stakes entail less control over the acquired firm.

The only exception is China, where privately owned enterprises tend to buy larger stakes than SOEs. This is supported by country-level data: in Australia for instance, Chinese SOEs demonstrate a "strong preference for controlling stakes in their target companies or greenfield projects", with 19 out of 23 companies analysed holding majority stakes in one or more Australian companies (KPMG, 2014). Ding et al (2014) nevertheless nuance this argument by looking into the specific markets of IM&A activity: the authors posit that although in general SOEs will prefer to use acquisitions to

enter foreign countries, they will pursue this strategy much less often when entering markets with strong technological or institutional development, due to greater institutional pressures in those markets.[20]

Table 2.1. **Summary of key features of private company and SOE M&A deals**

	SOEs			POEs		
	Domestic	International	Total	Domestic	International	Total
Average deal size (USD mil)	496.9	577.9	520.8	231.1	245.5	234.9
Deal characteristics (% of deals)						
Partial interest	52.8	54.9	53.4	32.2	28.5	31.2
Majority interest	14.3	10.7	13.3	8.9	11.3	9.5
Outright purchase	9.7	11.1	10.1	31.2	33.2	31.7
Other	23.2	23.2	23.2	27.7	27.0	27.6

iv) Soft business constraints, efficiency and risk-taking

First-order advantages to doing business – lower capital constraints, protected home markets and implicit government backing for SOEs – might not just facilitate politically-driven behaviour abroad, such as espionage or strategic resource control. Because of the softer business constraints that they imply, these features may also create incentives for higher risk-taking and lower efficiency in SOEs as compared to private firms. The potential economic implications (domestically and internationally) are less mediatised but deserve some attention.

The first assumption is that of greater moral hazard in SOE as compared to private investments: companies are more likely to engage in risky investments overseas if they know they can ultimately be bailed out by their home governments (lack of debt neutrality), if they can rely on secure revenue streams from their home base, and if they cannot be punished by shareholders (SOEs that are absolved from paying dividends or any other returns to shareholders can incur losses without fear of their owners selling their equity stake). Traditional literature on state ownership also holds that political interference comes at the expense of corporate profitability because of politicians' deliberate transfer of resources to their supporters (Shleifer and Vishny, 1986; Dong et al, 2014). State-owned banks might for instance be seen as vehicles for raising capital to finance projects with high social

returns, but possibly high-risk and low-profit financial returns, such as those undertaken by SOEs (Dong et al, 2014).

In addition to financial and commercial risks of the investments, SOEs might also be more willing to shoulder political risk. Indeed political economy would suggest that SOEs are less vulnerable to expropriation by host governments, because of the political weight that they carry (Cuervo-Cazurra et al, 2014). Using Chinese firm-level FDI information between 2003 and 2010, Duanmu (2014) corroborates this hypothesis, arguing that this protective effect varies with the strength of political relations between the home and host state, and the level of economic dependence of the host country on the home market. Further empirical verification (preferably across a range of home and host countries) may require analysis not only by target sector but by political risk rating of the target countries.

Turning next to the question of efficiency and profitability, the difference between domestically and internationally operating SOEs also comes to the fore. As pointed out in previous OECD work, numerous empirical studies conclude that SOEs tend to be less efficient and flexible than their private sector counterparts, due to adverse incentives such as the lack of hard budget constraints and low shareholder pressure for returns. This is a main *raison d'être* for OECD recommendations such as the *Guidelines on Corporate Governance of State-Owned Enterprises* (the recently reviewed "SOE Guidelines") (OECD, 2015a), which advise governments on how to reform and corporatise their SOEs to avoid resource waste and fiscal slippage. International business literature, too, has repeatedly questioned the long-term competitive viability of SOEs as international investors, with examples of spectacular business failures and overly ambitious SOE expansion plans.

Yet as with the risk-taking argument, this unfavourable picture of SOE complacency and inefficiency seems to hold more for domestic than for internationally operating SOEs. As put by Cuervo-Cazzura et al (2014), there appears to be a "new breed of SOEs that have shed some of the shortcomings of their predecessors as they focus more intently on the global arena". Out of the largest 100 firms by revenue in 2012, the authors find that 27 were SOEs (not engaged in cross-border investment) and 23 were "state-owned multi-nationals" (that is, engaged in cross-border investments). The latter were on average profitable, with a return on assets (ROA) of 3.44% and an operating margin of 14%. This compares quite well against averages of 3.19% and 5.7%, respectively, for the top 73 private-owned firms (Cuervo-Cazzura et al, 2014). Likewise, earlier research by OECD found little or no evidence of systematically lower rates of return in SOEs and inferred that the advantages conferred upon the SOEs were probably sufficient the compensate for the lower operational efficiency that they are

generally assumed to have (Christiansen, H. and Y. Kim, 2014). However, several of the cited studies use relatively old data and more recently a study of the Chinese corporate sector found a generally higher return on assets in private firms than in SOEs[21].

What are the systemic implications of these efficiency and risk-taking patterns in MNSOEs? If state-owned companies were in general higher risk-takers, and, benefiting from implicit government guarantees, commonly took on excessive debt while running inefficient business operations, systemic risks would arguably be quite high. These effects would be particularly exacerbated by crowding out of other, potentially more efficient and fiscally sustainable, investors. Market disruptions at national level would have detrimental ripple effects. The collapse of an "outward FDI bubble" could also significantly disrupt the global value chains into which MNSOEs have integrated themselves (Gestrin, 2014). Overall though, while further research remains necessary, the data above paints a more reassuring picture.

v) Responsible business conduct

Another pattern of SOE investment behaviour, which is less political or economic in nature, relates to standards of responsible business conduct (RBC). There are common perceptions that foreign state-owned companies might abide to different (possibly lower) standards of RBC (including environmental and labour standards) in their home market – and that unless the host economy has strong capacity for enforcing higher RBC standards across all firms in its jurisdiction, this behaviour may further be exacerbated when the firms operate overseas. Concerns of "foreign state immunity", as described earlier, could also in some cases limit the clout of host country governments on the operations of foreign SOEs (OECD, 2010b; OECD, 2009). Even in cases where home government backing is only implicit, SOEs may not be as responsive as private firms to the enforcement powers of local regulators, especially in areas of more normative standards such as RBC.

In practice, there is little evidence that state-owned companies operating abroad differ substantially in their RBC behaviour from equivalent private-owned companies originating in the same economy, and operating in the same destination market. In some cases SOEs may actually be held to higher standards than equivalent other companies, because of the reputational risk otherwise incurred by the home government. This for instance seems to be the case with Chinese companies, where the central government has developed RBC standards with a predominant focus on overseas investment by central SOEs (see Box 2.1; though as Box 1.1 points out, an RBC gap may persist between centrally and locally owned SOEs).

Box 2.1. **China's investments overseas and targeted guidance for responsible business conduct**

China's leading role as the recipient and source of investment is leading to increasing demand for more responsible business practices in China and by Chinese companies abroad, as well as demand from businesses for more guidance on how to meet these expectations. This has translated in some changes to legislation and to the development of business guidance in certain sectors. Interestingly, the focus of government efforts so far has been overseas investment. In 2008, the State-owned Assets Supervision and Administration Commission (SASAC) issued Guidelines to the State-owned Enterprises Directly under the Central Government on fulfilling Corporate Social Responsibilities. In 2013, the Ministry of Commerce (MOFCOM) and the Ministry of Environmental Protection (MEP) issued joint Guidelines on Environmental Protection in Investment and Protection Overseas. In 2014, MOFCOM stipulated in the Revised Measures for Foreign Investment Management that enterprises should require its overseas subsidiaries to abide by local laws and regulations and respect local manners and customs, perform social responsibility, and carry out activities in environmental protection, labour protection and enterprise cultural construction to better integrate into localities.

Going beyond RBC alone, the importance for Chinese SOEs to run at arm's length from the state was a focus of China's Third Plenum reform agenda, signaling a lessening of state involvement. The implementation of "market-orientated SOE reforms" was declared in November 2014 (Bowman et al, 2015). More specifically, it was decided to develop a 'mixed ownership economy', shift from managing state assets to managing state capital, promote a modern corporate system, and promote outbound investment in the future. These reforms should grant Chinese SOEs more discretion in their investment decision-making process and mitigate concerns regarding unfair competition vis-à-vis private competitors.

Source: OECD (2015n).

2.3. Equipping national and international investment policy frameworks to deal with cross-border SOE investments

As relatively new actors in globalisation, SOEs reflect only one of the ways in which the nature of international investment and the structures of multinational enterprises continue to evolve. These evolutions are prompting governments to develop new domestic as well as multilateral options to deal with the associated policy challenges and possible risks. For example a few countries have strengthened their domestic regulatory frameworks to allow for the screening or review of FDI (especially M&A) by foreign SOEs. These regulatory instruments include the clarification of review processes

for investments by foreign SOEs (as in Canada, among others). In some cases (such as the U.S. and Australia) these reviews are cross-sectoral, while for Russia they are sector-specific (focusing on defence, national resources and infrastructure). At the international level, international treaty practice is also evolving and an increasing number of bilateral investment treaties (BITs) stipulate coverage of investments by SOEs. "Mega-regional" treaties currently under negotiation, such as the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TTIP) could also eventually include provisions in support of a level playing field between SOEs and private investors.

1) Domestic policy frameworks

In most cases, foreign SOEs (as well as state-owned investment funds such as SWFs) are treated in the same manner as foreign private investors under domestic regulatory frameworks. However, some countries have established domestic rules and regulations that specifically apply to foreign SOEs. In most of these cases national security or national interest is the key justification invoked for these measures. Broadly, policy approaches to address national security or national interest concerns related to foreign SOE investment include a mix of: (i) partial or total prohibitions in specified sectors (prohibitions); (ii) prior government review of all foreign SOE investment proposals that meet legally defined criteria (review); and (iii) screening procedures that identify individual, potentially problematic transactions, which are subsequently subjected to reviews (screenings).

Among the 46 adherent countries to the OECD Declaration on International Investment and Multinational Enterprises, six countries - Australia, Iceland, Israel, Mexico, Spain, Costa Rica and Turkey – have thus reported specific restrictions on investments by foreign GCIs (this includes both SOEs and SWFs). These countries have either lodged reservations to the OECD Code of Liberalisation of Capital Movements and/or notified exceptions or included measures in the transparency list of the OECD National Treatment Instrument (See Box 2.2). Among these reservations or measures, some apply to all investments across sectors (e.g., Australia, Iceland, Spain), while others are sector specific (e.g., Costa Rica, Israel, Mexico, Turkey).

Over the past decade, a number of countries that participate in the OECD FOI Roundtables have also introduced or significantly amended policies specifically tailored to address national security concerns stemming from foreign investment. While military threats have dominated the perception of national security for the latter decades of the 20th century - reflected in foreign ownership ceilings in defence production, for instance - a broader scope of economic sectors are henceforth considered to be

potentially national security sensitive; driven by privatisation of previous state monopolies in these sectors, these include energy, telecommunications, and healthcare among others. While such national security measures are most often indifferent to public and private ownership, certain jurisdictions distinguish their approach depending on whether the inward investor is private or government-owned.

Box 2.2. **Measures relating to foreign GCIs reported under OECD instruments**

While the OECD instruments including the OECD Code of Liberalisation of Capital Movements ("Code")[1] and the OECD National Treatment Instrument ("NTI")[2] are generally ownership neutral and apply to all investors regardless of the ownership natures of the investors, some countries have reported their policies relating to GCIs by lodging reservations to the Code and/or notifying exceptions or including other measures in the transparency list for the NTI. The examples of such reporting relating to GCIs are described below.[3]

- Australia maintains reservations which apply to "proposals involving direct investment by foreign governments or agencies".
- Costa Rica has reported that concessions for mining or exploration of ores may not be granted to foreign governments or their representatives in the NTI exception list.
- Iceland prohibits "investment by foreign states or state-owned enterprises, unless an authorisation is granted", as reserved under the Code and notified under the NTI.

Israel has reported that in cable broadcasting a license may not be granted to an applicant in which a foreign government holds shares, unless the Minister of Communications authorises an indirect holding in the licensee of up to 10% by such an applicant as reserved under the Code and notified under the NTI.

- Spain reserves a right to restrict "investment originating in non-EU member countries by governments, official institutions and public enterprises" under the Code.
- Turkey has reported in the NTI transparency list that "no real or legal person acting for or on behalf of financial or beneficial interests of a foreign state may hold petroleum rights or conduct any business activity related with petroleum without the authorisation of the Council of Ministers".

1. See *www.oecd.org/daf/inv/investment-policy/codes.htm*.
2. See*www.oecd.org/daf/inv/investment-policy/nationaltreatmentinstrument.htm*.
3. See also page 19 of "Foreign government-controlled investors and recipient country investment policies: a scoping paper" by the OECD (2009).

Source: Shima (2015).

In a 2015 OECD Survey of Investment Policies Related to National Security, government control was found to be a structuring criterion of investment policies related to national security within the sample of countries surveyed. [22] Among the 17 countries surveyed in the study, three explicitly treat foreign SOEs differently from private investors: Australia, the Russian Federation and the United States, which all have established specific rules for the purpose of managing any related national security risks.[23] Canada is a specific case: whereas its national security review does not explicitly distinguish between foreign private investment and SOE investment, concerns related to non-commercial activity by SOEs are dealt with under the general Investment Canada Act "net benefit" review. Meanwhile in Australia and the United States, SOE investments are systematically subjected to reviews, without the filters – trigger thresholds or preliminary assessments – that apply to foreign private investment. In the Federation of Russia, equity caps for foreign investment in certain enterprises or industries are lower for SOEs. Box 2.3 summarises the respective approaches taken by Canada and Australia.

Explicit different treatment between SOEs and private investors for national security reasons is therefore applied by only a few countries; this likely also holds for the countries not surveyed (for instance, Indonesia, Nigeria, Serbia, and South Africa do not have specific rules for SOEs either under their review mechanisms). Nonetheless this does not preclude that investments by foreign SOEs may receive greater scrutiny than investments by non-state owned enterprises in other countries' screening or review mechanisms. For example, under New Zealand's inward investment review mechanism, "foreign government investors with non-commercial motivations" may be part of the assessment conducted by the authorities of whether the investment proposal meets the 'economic interests' factor to pass the national interest test.[24] Indeed overall, while the rules discussed above do not appear to seek to deter investments by foreign SOEs as such or to treat them less favourably, it is likely that SOEs are subject to closer screening or that they are more thoroughly reviewed, as compared to private investors. With more data availability, it would be interesting to investigate whether SOE reviews take longer and whether the overall effect on investment is actually deterrent.

Box 2.3. **Measures taken by Australia and Canada relative to inward IM&A by SOE investors**

Canada and Australia both receive above-average inward IM&A by SOE investors, which could explain why both of these countries have been among the more active in formulating and communicating policy positions specifically addressed to SOE investments. For instance under the Australian Foreign Acquisitions and Takeovers Act 1975 (FATA), the Australian government is empowered to examine proposed foreign investments and to decide if they are contrary to Australia's national interest. Foreign governments and their agencies (including SOEs and SWFs), in particular, must obtain prior approval before making direct investments, irrespective of the size of the investment, while in the case of private foreign investors, prior approval is in general necessary only if their investment exceeds certain thresholds (based on total assets or transaction values)[25]. The Guidelines for Foreign Government Investment Proposals (produced by the government in 2008) further explain that the fact that these investors are owned or controlled by a foreign government raises additional factors that must also be examined – notably whether the investment is commercial in nature or whether the investor may be pursuing broader political or strategic objectives that may be contrary to Australia's national interest.[26]

In Canada, SOE Guidelines were issued in 2007 and revised in December 2012, now supplemented with a "Statement Regarding Investment by Foreign State-Owned Enterprises"[27] which emphasizes that free enterprise principles and industrial efficiency are considered in reviews of investments by SOEs. As announced in December 2012 (in response to a substantial increase in SOE investment since 2008 and as part of the new SOE guidelines), future acquisitions of control Canadian oil sands businesses by SOEs would for instance henceforth only pass Canada's investment "net benefit" test in "exceptional circumstances". The 2013 amendment of the Investment Canada Act covers a broad range of government entities (including foreign governments acting as investors in their own right, and individuals acting on behalf of a government), and creates distinct thresholds for private and SOE investors for triggering a review. Most recently, as of April 2015 another amendment to the Investment Canada Act has again changed these thresholds: higher, enterprise value-based thresholds now apply to privately-owned WTO member investors - as opposed to SOE investors (CAN $600 million enterprise value versus CAN $369 million asset value). The SOE threshold and the privately-owned WTO member investor threshold once fully incremented to $1 billion enterprise value) are adjusted annually to reflect change in Canada's nominal GDP over the previous year. The formula is available in the legislation.

As regards any discriminatory treatment on the basis of government ownership post-establishment of investors, beyond investment reviews most relevant measures pertain to tax and competition (as discussed in other

chapters of this report). In these fields as well as in investment policy *per se*, the evolutions in the use of 'foreign state immunity' are relevant. As mentioned earlier, a range of countries are now ratifying the United Nations or European Union Conventions, or developing national jurisprudence, aimed at codifying commercial exceptions to such reaches of foreign sovereign immunity. While some of these have legislation that explicitly excludes commercial activities from sovereign immunity, others (e.g. France, Germany and Italy) rely instead on international legal principles and jurisprudence. In general the commercial activities exception can help create a more level playing field between vis-à-vis private investors. This said, it does not completely eliminate concerns for recipient country law enforcement. For example, it remains true that while the commercial entity is normally subject to the full force of recipient country law, its home state still enjoys immunity; thus, if the home government instigates illegal activities via its commercial entity, it is still immune from recipient country enforcement actions (OECD, 2009).

Recognising that investment screenings and reviews may be a rather blunt form of addressing inward SOE investments, several countries are also exploring alternatives in the domestic policy arena. These range from: substantially liberalising investment approval requirements (so as to only apply these to the largest investment proposals, while strengthening the domestic regulatory environment to ensure that SOE and other companies' operations are subject to similar enforcement); through intermediate options (including modifying SOE incentives for good commercial or corporate governance behaviour, for instance by establishing an accreditation process for SOEs or allowing various screening dispensations for SOEs with a proven track record); to the most restrictive stances (systematically reviewing all inward SOE investment irrespective of size). As highlighted by the Business Council of Australia which has comprehensively laid out several of these options, they should not be considered as mutually exclusive – nor should they send a signal that the host country is closed to business. Rather, several of these domestic policy options could be "packaged together" (in complement to the international policy measures discussed below) and be collectively used to "raise community confidence" both domestically and internationally (BCA, 2014).

2) International (treaty) practice

Policy responses to international investments by SOEs are still very incipient, as governments seek to strike a balance between keeping markets open to international investment, irrespective of ownership, and ensuring that MNSOEs and privately owned firms compete on a level playing field. Currently therefore, analysis of how SOEs are covered in investment treaty

practice is based mainly on over 3 000 bilateral international investment agreements (IIAs) that provide substantive protections to foreign investors and establish procedures for enforcement of these protections (Shima, 2015b).

i) Standing of state-owned enterprises in investment treaties

The investor protection and liberalisation provisions in investment treaties are generally accompanied by procedures for investor-State dispute settlement (ISDS). It appears that almost all investment treaties also contain state-state dispute settlement (SSDS) provisions. (See Box 2.4)

Research is on-going regarding the standing of SOEs to bring claims under the ISDS provisions of investment treaties, especially given the growing amount of cross-border investment by SOEs as well as by state-owned investment funds (notably SWFs). As summarised by Feldman (2014), the inclusion of investor-State, but not State-to-State, disputes within the scope of investment treaty protections is arguably reflected in both the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention, which is limited to investment disputes between a Contracting State and a "national" of another Contracting State under Article 25(1)) and bilateral investment treaties (BITs, where jurisdiction is generally limited to disputes between a State Party and an "investor" of another Party). The extent to which either mechanism can actually be applied to SOE investment thus generally depends in large part on the respective definitions of "national" under ICSID and "investor" within BITs.

The issue of the approach applicable to SOE claims in ISDS has only been squarely addressed by one publicly-available investment arbitration decision, *CSOB v. The Slovak Republic*. In that case, the investor had a legal personality but was controlled by a state (which retained 65% of the capital). The tribunal noted that the term "national" in the ICSID Convention did not exclusively concern the companies with private capital but also companies partially or entirely controlled by a state (OECD, 2009). One commentator has summarised the tribunal's reasoning as a finding that "so long as the activities of a State-owned entity are commercial in nature, a claim submitted by such an entity to ICSID arbitration will give rise to an investor-State, rather than a State-to-State, dispute – even if the entity engages in activities that are 'driven by' State governmental policies and is controlled by the State such that it is "required" to do the State's 'bidding'" (Feldman, 2014). This would be relevant to the discussion on non-commercial or strategic objectives of SOE investment, raised in Section 2. Nevertheless, there is a grey area. Other academic and policy experts consider that "a State-owned entity should not be disqualified as a 'national

of another Contracting State' [under Article 25(1) of the ICSID Convention] unless it is acting as an agent for the government or is discharging an essentially governmental function" (Broches, 1972; Schreuer et al.)

Box 2.4. **ISDS and State-state dispute settlement (SSDS)**

Many governments have expressed concerns about the uncertainty linked to the perceived inconsistency of treaty interpretation in Investor-State dispute settlement (ISDS). In the context of discussions about the interpretation of investment treaties in March 2014, a number of participants of the OECD FOI Roundtable suggested consideration of the potential role of State-to-State dispute settlement (SSDS) as a potential method to improve the interpretation of investment treaties. A survey of the 107 IIAs drawn from the OECD treaty database, concluded by 36 economies that participate in the FOI Roundtables, noted that all surveyed treaties included SSDS provisions – that is, states' include SSDS in their investment treaties even more often than ISDS. Academic research in this area is also growing as part of the broad wave of interest in the role of states under investment treaties.

SSDS has been advanced by some as a possible way to address inconsistencies and provide greater certainty and predictability to governments, investors and others. However, the current stock of investment treaties generally only very lightly regulates SSDS and rarely specifically addresses its interaction with ISDS. A rough typology of possible SSDS claims under investment treaties includes: (i) claims seeking a "pure" interpretation of a provision of the treaty unrelated to a particular claim of breach or factual dispute; (ii) claims of breach by another State party including diplomatic protection claims; and (iii) claims for a declaratory judgment relating to a particular measure or fact situation. The articulation between the two types of dispute settlement may merit further consideration as debate on the role of SOEs in the global marketplace evolves.

Source: OECD (2014f).

Several cases exist of foreign investors bringing ISDS claims against governments based on alleged misconduct by SOEs. Generally these relate to alleged misconduct by an SOE owned by the host government, which is operating domestically (for instance ICSID Case No. Arb/97/7, 2000: *Emilio Agustin Maffezini v. The Kingdom of Spain*) (Kawase, 2014).

Under BITs, there is generally no distinction between state-owned and privately owned entities in the definition of "investor". This is confirmed by OECD analysis: of 1 813 IIAs surveyed in 2014, 84% do not explicitly

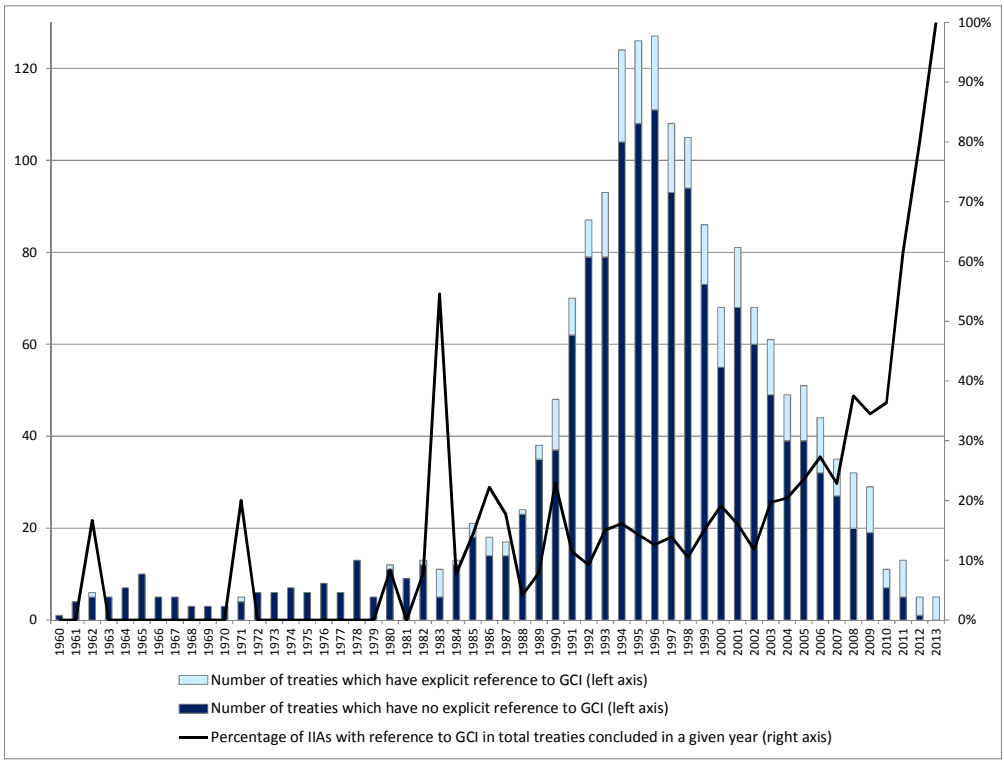
mention any type of GCI (be it SOE, state-owned investment funds, or government) as such, in the definition of investor (Shima, 2015). For example, the Energy Charter Treaty defines an investor as a natural person or a company and the definition does not refer to state ownership.[28] A few BITs expressly specify that state-owned entities can qualify as an "investor" or "company" of the other party to the treaty. Other treaties refer to the "for profit" nature of the investor's activities (Feldman, 2014).

More recent treaties now more frequently contain specific references to SOEs or GCIs (see Figure 2.7). For instance, the definition of UAE investors in UAE–China BIT (1993) explicitly includes the Federal Governments of the UAE, as well as the Local Governments and their local and financial institutions (Shima, 2015).[29] Meanwhile 287 treaties (26% of those surveyed) specify that SOEs are covered, and 3 specify that they are not. The most frequent references to SOEs are made by Australian, Canadian and American IIA, whereas Kuwait, Qatar, UAE and Saudi Arabia tend to rather contain governments within the scope of investors (6% of the survey).

Provisions explicitly pointing to fair competition between SOEs and other companies are also on the rise, mainly in treaties negotiated by the United States, Australia, New Zealand and Singapore (Shima, 2015). All five of the surveyed IIAs concluded in 2013 explicitly covered international investments by GCIs, illustrating both the rising importance of this question for investment policy makers internationally, and the general trend towards more detailed and sophisticated treaties.[30] However, the fact that the vast majority of existing IIAs do not mention SOEs in the definition of investor could give rise to uncertainty with respect to the application and coverage of these agreements. The issue may arise in treaty-based arbitration cases (Shima, 2015).

Nevertheless, the increasing explicit acceptance of coverage of SOEs in the admittedly much smaller number of recent treaties suggests that in this field, as in other areas mentioned below, there is no suggestion of a 'protectionist backlash' against the growing presence of cross-border SOE investment. Indeed, explicit extension of treaty coverage to SOEs, to the extent it exists, reflects intent to encourage cross-border SOE investment as well to clarify the applicable rules.

Figure 2.7. **Total number of IIAs concluded per year in comparison with IIAs with an explicit reference to government-controlled investors (GCI)**



Source: Shima (2015).

ii) "Mega-regional" treaties

Beyond bilateral IIAs, "mega-regional" treaties are also gaining ground on the international investment agenda. A number of major international negotiations that will include provisions dealing with international investment, including the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TTIP), intend to address the issue of "competitive neutrality". For instance the European Union's initial proposal for legal text on "State Enterprises and enterprises granted special or exclusive rights or privileges" in TTIP, tabled for discussion with the US in the negotiating round of 14-18 July 2014 and made public on 7 January 2015, states that "government ownership is not problematic in itself but certain advantages provided by governments must be addressed" (EC, 2015). The exact form that such provisions will take will not become clear until negotiations have been completed.

3) OECD instruments

As summarised by Shima (2015), most existing international instruments relating to investment, including OECD instruments (see Box 2.5), do not explicitly distinguish on the basis of ownership.[31] On the other hand, the Multilateral Investment Guarantee Agency Convention (MIGA Convention) clearly includes non-privately owned investor in the definition of "eligible investors" by providing that an eligible investor is a natural person or juridical person, whether or not it is privately owned, if it operates on a commercial basis.[32] As for the OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations, they do not distinguish government-controlled investors from private investors unless adherents have lodged reservations or notified national treatment exceptions (see above – some such reservations and exceptions cut across all sectors, while others are sector-specific).

2.4. Conclusion

The preceding sections provide a typology of dominant concerns relative to investment implications of cross-border SOE operations. Perhaps the strongest empirical conclusion from the data relates to the protected home base of SOEs (non-contestability in the home market and asymmetry in ease of acquisition of SOEs by foreign investors). Yet this still needs careful investigation at the sector-specific level. Further research would also be needed regarding the risk levels of firms acquired by SOEs and private firms, and their valuation, to verify these concerns empirically. Going beyond IM&A activity and considering greenfield investments could also paint a clearer picture of SOE internationalisation.

Most countries that have begun reacting to this trend have done so within their domestic investment regimes alone, or bilaterally, and largely in a manner that seeks to gather more information on the state-owned investor without blocking the investment *per se*. In their majority, these different policy responses are procedure-based, and pertain to the second order effects of SOE internationalisation: possible distortionary behaviour in international markets, and pursuit of non-commercial incentives for investment. Far fewer tools are being developed or employed – at least by investment policy makers – to address the sources of undue advantage. While we see forms of diplomatic, or investment review-based interventions, there is far less attention to behavioural approaches which could help directly shape the incentives of public and private firms.

At the international and multi-lateral level, there has been no collective response to date. This limited policy response may reflect the fact that, at a time when global investment flows remain 40% below their pre-financial

crisis levels, governments are wary of discouraging any source of international investment. It probably also reflects the challenges involved in breaking new ground in international investment rule-making at a time when many features of the existing global investment regime are being challenged, including ISDS and the growing complexity of a system made up of thousands of different bilateral and regional investment agreements (Gestrin, 2014).

Box 2.5. **OECD instruments and state ownership**

OECD instruments, including the OECD Declaration on International Investment and Multinational Enterprises (which contains the National Treatment Instrument) and the OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations (Codes) do not distinguish government controlled investors from private investors, unless the parties have lodged reservations to the Codes and/or notified National Treatment exceptions. In particular, the Users' Guide for the Codes explains that "government-owned industrial, commercial or financial enterprises are treated like private enterprises under the Codes. Where government owned enterprises act, for instance, as service suppliers, host countries should accord them the same rights to provide cross border services as are enjoyed by private enterprises."

The 2008 OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies represents perhaps the first example of an international agreement specifically addressed to the issue of keeping markets open to international investment involving governments. It was followed by the 2009 OECD Guidelines for Recipient Country Investment Policies relating to National Security, providing specific recommendations for recipient country policies that help to make these policies both effective and to ensure that they are not used as disguised protectionism.

OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015) are the first international recommendation to help governments in improving the governance of SOEs. The Guidelines are backed by subsidiary guidance documents, which provide additional standards and good practices as well as advice on implementation. Chapter I of the Guidelines states that governments should ensure a level playing field in markets where SOEs and private companies compete in order to avoid market distortions.

The 2010 update to the Model Tax Convention[1] approved by the OECD Council in July 2010 added the commentary dealing with the application of tax treaties to state-owned entities, including sovereign wealth funds.

1. Available at *www.oecd.org/tax/transfer-pricing/45689328.pdf*.

Source: (OECD, 2011, 2008, 2009, 2015a,2010).

Chapter 3

State-owned enterprises as actors in international trade [33]

SOEs are growing actors in international trade and global value chains. This chapter explores the extent to which the international trading system, under the rules of the WTO and other international agreements, are equipped to cover market distortions caused by financial and regulatory support granted to (and by) SOEs. The chapter points out that trade rules are ownership neutral, but it remains debated whether a specific set of rules are need to cover SOEs. The chapter explores regulatory frameworks and practices at the domestic level which can safeguard a level playing field. It covers existing binding international agreements and treaty practice, and explores potential gaps in their coverage. It points to the need for sounder incentives for states and SOEs to abide by market and transparency principles, including the consideration of rules on subsidies granted to SOEs as a priority for further deliberations in the international trade context.

3.1. The rules-based trading system, states and SOEs

The market access and other obligations undertaken mutually by the 161 members of the WTO reflect both their recognition of the benefits that can stem from international exchange of goods and services as well as the conditions which must be fulfilled for these benefits to materialise, namely, non-discrimination and respect of market principles. As a general rule WTO Agreements impose obligations on governments—as opposed to private or non-governmental entities—and they aim to protect the trading conditions of private economic operators engaged in international trade from possible non-economic motivations of governments.

A key concern in this context, which is related—but not exclusive—to state-owned enterprises (SOEs), is that governments may provide some firms with certain financial or regulatory advantages, or influence them to confer such advantages on other entities. If this is the case, goods and services may end up being produced not by those who can do it most efficiently, but by those that receive the greatest advantage. Capital and other productive resources may be allocated in unproductive ways and, therefore, the rationale for—and the benefits of—more open policies related to international trade and investment may be undermined. At the same time various enterprises that might be linked to governments in some ways can operate on a fully commercial basis and in respect of market principles. The challenge then is to minimise any distortionary effects on international trade and investment created by advantages granted to enterprises by governments and, at the same time, restrain undue protectionism that may be directed at some of these entities.

However, it is not clear whether policy responses should target specific types of enterprises or whether they should be more universal. Ownership is neither necessary for governments to influence enterprises' operations, nor does it inevitably entail such influence. Since state-owned and private firms alike can in principle be favoured by the state, some argue for ownership-neutral rules—much like the current WTO rules—and advocate disciplining the use of various state-granted advantages that can influence the competitive position of firms engaged in commercial activities rather than focusing on ownership per se. Yet, it is also clear that ownership implies certain interests, rights and obligations characteristic to an owner and thus it can be argued that exertion of state influence on SOEs is more likely – and often less easy for outsiders to detect. Furthermore, state ownership also means that the government combines the roles of a regulator, regulation enforcer and business owner. These are some of the arguments for ownership-specific approach to regulation taken in some preferential trade agreements (PTAs).

Recent work in this area by the OECD Trade Committee reveals that it is not yet obvious which approach is likely to dominate in the future. At this stage, in order to consider a broad enough set of issues, the analysis of state influence on enterprises should ideally take an inclusive approach covering state-owned, state-controlled or otherwise state-influenced enterprises, "national champions" as well as private firms. It should also cover a broad range of state-granted advantages.

3.2. Concerns related to internationalisation of SOEs from a trade perspective

While it is virtually impossible to provide a comprehensive assessment of the many types of enterprises that can be influenced by states, state-owned enterprises (SOEs), are relatively well defined and this is where recent quantification efforts have been concentrated. They revealed that presence of SOEs in the global economy has grown considerably in recent years. As illustrated in an earlier section some of them feature prominently among the world's largest and most influential enterprises and are important players in several internationally contestable and vertically-linked economic sectors (OECD, 2013a; Kowalski, P., et. al, 2013; Christiansen, H. and Y. Kim, 2014). These include, for example, mining of coal and lignite and mining support activities, civil engineering, land transport and transport via pipelines, extraction of crude petroleum and gas, telecommunication and financial services as well as manufacturing of metals (Kowalski, P., et. al, 2013).

One reason for the increased presence of SOEs in global markets is the recent dynamic growth and trade expansion of some of the large emerging market economies with important state sectors. Other factors include internal circumstances concerning state firms as well as the dynamics of markets in which they operate. However, adoption by some countries of deliberate policies supporting the foreign expansion of state enterprises may also have played a role (Kowalski, P., et. al, 2013). In addition, the increasing interconnectedness of national economies via deepening trade and investment links in goods and services sectors, proliferating international supply chains and "servicification" explain further why the effects of state policies—even those oriented primarily towards specific domestic firms and sectors—are perceived to span more easily across the whole economy and national borders.

While it is widely acknowledged that there are legitimate economic and non-economic reasons for establishing and maintaining such enterprises, these reasons become more blurred in an international context. In a domestic context, the government and the public can in principle agree on objectives of state enterprises, types of preferential treatment afforded to them as well as on

ways of minimising any unintended distortions. In an international context, however, citizens in different countries can have diverging views on the role of such enterprises in the economy and thus on the rationale for and forms of special and preferential treatment afforded to them. Approaches to regulating the state sector can vary across countries which in itself may distort the international level playing field. Enforcement may be less stringent or simply violated when state enterprises compete in foreign markets. Disclosure and transparency, which take on a particular importance in state sector management, are also more elusive in an international context.

3.3. Regulatory frameworks and practices which can safeguard non-discrimination and respect of market rules by internationally-active SOEs

As highlighted at the beginning of this chapter, when considering regulatory approaches that could alleviate some the concerns associated with internationally-active SOEs, it is important to consider to what extent state ownership of enterprises is a useful concept in minimising discriminatory behaviour of states in international markets. Another important question is whether legitimate domestic and international objectives can be achieved more efficiently through promotion and international co-ordination of domestic reforms and implementation of good practices and guidelines with respect to the state sector, or through additional binding international rules, or by combining the two approaches.

1) Domestic reforms and softer forms of international co-ordination

Public policy purposes which state enterprises often pursue may not easily yield themselves to a more stringent regulation at the international level. This suggests that domestic reforms and softer forms of international co-ordination of these reforms might have better potential for covering a wider range of issues and delivering desired outcomes. The policy areas that are relevant in this respect include national competition policies, rules with respect to corporate governance of the state sector and the so-called "competitive neutrality" policies which encompass a set of domestic measures that aim to identify and neutralise competitive advantages of state entities.

Competition policies focus mainly on actions of enterprises which have effects in national markets and usually apply regardless of the type of relationship between enterprises and states or nationality. However, in some jurisdictions SOEs or other state enterprises may be excluded from their application (OECD, 2015a). Competition policies normally contain provisions addressing predatory abuse of dominant position, including predatory pricing strategies, and anticompetitive effects associated with merger and acquisition

activity of state enterprises. However, they rarely deal with subsidies or state aid which, as we have seen earlier in this chapter, is an important concern associated with SOEs.[34] (See also Chapter 4).

The OECD *Guidelines on Corporate Governance of State-owned Enterprises* (See Chapter 5) (OECD, 2015a) recommend the maintenance of a level playing field among state-owned and privately owned incorporated enterprises operating on a commercial basis and elaborate on a number of guiding principles that can help achieve this objective. They focus on corporate outcomes while giving individual jurisdictions freedom to decide on whether and how to achieve these. As discussed in a later section, some of their potential limitations include their lack of explicit consideration of cross-border issues, as well as their voluntary nature and lack of regular assessment of implementation. Nevertheless, they can be a useful reference for advocacy-oriented approaches to creating a more level playing field in the international market and can also have more direct applications in international context. For example, they have been used as a benchmark to assess the quality of potential state investors by investment regulators and they were recently referenced in the transparency and corporate governance section of the EU's initial proposal for legal text on state-owned enterprises in the currently-negotiated Transatlantic Trade and Investment Partnership.[35]

Some countries go beyond corporate governance issues in their regulation of state entities and pursue additional national policies that aim to identify and neutralise their competitive advantages with respect to taxation, financing costs, regulatory neutrality as well as profit orientation (OECD, 2012a). Among the OECD countries, Australia and the EU are considered to have the most advanced approaches in this area.[36] The supranational character of the EU's arrangements, their ownership-neutral character and the fact that they comprise competition, state aid, transparency and government procurement rules, make them particularly interesting in the context of cross-border issues considered in this chapter. However, apart from the EU, competitive neutrality policies are adopted on a unilateral basis and thus do not deal with any potential differences across countries with respect to the rationale for maintaining state enterprises and bestowing them with advantage in the first place. International discussions on co-ordination of competitive neutrality approaches are relatively nascent.[37]

Both corporate governance and competitive neutrality policies are formulated with respect to own state entities and they do not shield countries from the effects of foreign state enterprises. It is also not entirely clear to what extent they can effectively protect foreign private entities competing with domestic state enterprises[38] and they may be less rigorously applied when it is competition abroad of domestic state enterprises that is in question.

2) Binding international rules

Some of the relevant binding international rules that can discipline discriminatory government behaviour related to international trade activities of state enterprises can already be found in the WTO law as well as certain regional and preferential trade agreements (PTAs).

First, there are the WTO rules that discipline some of the trade distorting government policies that may be directed at state enterprises. For example, the current rules of the Subsidies and Countervailing Measures Agreement (SCMA) prohibit or discipline various forms of trade-distorting financial or in kind preferences irrespective of whether they are granted to state or private firms (see Box 3.1). Another example is GATT Article III on national treatment which bans discrimination favouring domestic producers, including state enterprises.

Box 3.1. **Article 1.1(a)(1) of the Subsidies and Countervailing Measures Agreement**

Article 1.1(a)(1) of the SCMA provides:

For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments

Source: WTO Subsidies and Countervailing Measures Agreement.

In addition, in principle all WTO obligations (e.g. subsidies, most-favoured nation, national treatment, bans on import and export restrictions, etc.) can be applied to state and private enterprises if the complainant in a dispute is able to demonstrate that such enterprises are acting under governmental instructions. For example, whether state enterprises are

disciplined by the SCMA rules as granters of subsidies depends on whether they can be considered a "public body" (see Box 3.2). The WTO case law has recently established that "public body" must be "an entity that possesses, exercises or is vested with governmental authority" (Kowalski, P and K. Perepechay, 2015). It has been established that ownership is a relevant criterion in the determination of whether an entity is a "public body", but it is not a determining factor (Box 3.2). This approach does not single out any particular type of entities which can be considered as vehicles of subsidies which lends it useful flexibility. On the other hand, it can be seen as creating uncertainty.

Box 3.2. **WTO case law interpretation of the "public body" term**

Excerpts from the Appellate Body report on United States — Countervailing Measures on Certain Hot-Rolled Carbon Steel Flat Products from India (DS436) concluded in 2014 (WTO, 2014) which draw on findings from US – Anti Dumping and Countervailing Duties (China) (DS379) concluded in 2011 (WTO, 2011) give the following interpretation of the term "public body" within the meaning of the SCMA:

"Regarding the meaning of the term "public body", the Appellate Body found, in US – Anti-Dumping and Countervailing Duties (China), that a "public body within the meaning of Article 1.1(a)(1) of the SCM Agreement must be an entity that possesses, exercises or is vested with governmental authority."[1] In determining whether or not a specific entity is a public body, it may be relevant to consider "whether the functions or conduct are of a kind, that are ordinarily classified as governmental in the legal order of the relevant Member."[2] The Appellate Body stated that the classification and functions of entities within WTO Members generally may also bear on the question of what features are normally exhibited by public bodies.[3] The Appellate Body added that "just as no two governments are exactly alike, the precise contours and characteristics of a public body are bound to differ from entity to entity, State to State, and case to case."[4] The Appellate Body explained that, in some cases, such as when a statute or other legal instrument expressly vests authority in the entity concerned, determining that such entity is a public body is a straightforward exercise. In other cases, the picture may be more mixed, and the challenge more complex.[5]

The Appellate Body further stressed that the absence of an express statutory delegation of governmental authority does not necessarily preclude a determination that a particular entity is a public body.[6] Instead, there are different ways in which a government could be understood to vest an entity with "governmental authority", and therefore different types of evidence may be relevant in this regard. The Appellate Body stated that evidence that "an entity is, in fact, exercising governmental functions may serve as evidence that it possesses or has been vested with governmental authority".[7] …/

Box 3.2. **WTO case law interpretation of the "public body" term** (*cont.*)

The Appellate Body added that "evidence that a government exercises meaningful control over an entity and its conduct may serve, in certain circumstances, as evidence that the relevant entity possesses governmental authority and exercises such authority in the performance of governmental functions."[8] The Appellate Body stressed, however, that "the existence of mere formal links between an entity and government in the narrow sense is unlikely to suffice to establish the necessary possession of governmental authority".[9] Instead, "[a]n investigating authority must, in making its determination, evaluate and give due consideration to all relevant characteristics of the entity and, in reaching its ultimate determination as to how that entity should be characterized, avoid focusing exclusively or unduly on any single characteristic without affording due consideration to others that may be relevant".[10] Thus, the mere ownership or control over an entity by a government, without more, is not sufficient to establish that the entity is a public body."

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[1] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 317.

[2] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 297.

[3] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 297.

[4] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 317.

[5] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 318.

[6] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 318. As the Appellate Body observed, "[w]hat matters is whether an entity is vested with authority to exercise governmental functions, rather than how that is achieved". (Ibid. (emphasis original)).

[7] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 318.

[8] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 318.

[9] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 318. The Appellate Body also explained that panels and investigating authorities are called upon, in all instances, "to engage in a careful evaluation of the entity in question and to identify its common features and relationship with government" (ibid., para. 319), and that the "mere fact that a government is the majority shareholder of an entity does not demonstrate that the government exercises meaningful control over the conduct of that entity" (ibid., para. 318).

[10] Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 319. (fn omitted)

Source: WTO (2014).

Box 3.3. **GATT Article XVII**

State Trading Enterprises

1.* (a) Each contracting party undertakes that if it establishes or maintains a State enterprise, wherever located, or grants to any enterprise, formally or in effect, exclusive or special privileges, such enterprise shall, in its purchases or sales involving either imports or exports, act in a manner consistent with the general principles of non-discriminatory treatment prescribed in this Agreement for governmental measures affecting imports or exports by private traders.

(b) The provisions of subparagraph (a) of this paragraph shall be understood to require that such enterprises shall, having due regard to the other provisions of this Agreement, make any such purchases or sales solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales.

(c) No contracting party shall prevent any enterprise (whether or not an enterprise described in subparagraph (a) of this paragraph) under its jurisdiction from acting in accordance with the principles of subparagraphs (a) and (b) of this paragraph.

2. The provisions of paragraph 1 of this Article shall not apply to imports of products for immediate or ultimate consumption in governmental use and not otherwise for resale or use in the production of goods* for sale. With respect to such imports, each contracting party shall accord to the trade of the other contracting parties fair and equitable treatment.

3. The contracting parties recognise that enterprises of the kind described in paragraph 1 (a) of this Article might be operated so as to create serious obstacles to trade; thus negotiations on a reciprocal and mutually advantageous basis designed to limit or reduce such obstacles are of importance to the expansion of international trade.*

4. (a) Contracting parties shall notify the CONTRACTING PARTIES of the products which are imported into or exported from their territories by enterprises of the kind described in paragraph 1 (a) of this Article.

(b) A contracting party establishing, maintaining or authorising an import monopoly of a product, which is not the subject of a concession under Article II, shall, on the request of another contracting party having a substantial trade in the product concerned, inform the CONTRACTING PARTIES of the import mark-up* on the product during a recent representative period, or, when it is not possible to do so, of the price charged on the resale of the product. …/

Box 3.3. **GATT Article XVII** *(cont.)*

(c) The CONTRACTING PARTIES may, at the request of a contracting party which has reason to believe that its interest under this Agreement are being adversely affected by the operations of an enterprise of the kind described in paragraph 1 (a), request the contracting party establishing, maintaining or authorising such enterprise to supply information about its operations related to the carrying out of the provisions of this Agreement.

(d) The provisions of this paragraph shall not require any contracting party to disclose confidential information which would impede law enforcement or otherwise be contrary to the public interest or would prejudice the legitimate commercial interests of particular enterprises.

Source: GATT/WTO.

In addition, a number of specific WTO provisions discipline some practices in which certain types of enterprises can be used by governments as vehicles to influence international trade. For example, Article XVII of the GATT (Box 3.3) and its Understanding (Box 3.4) require WTO members to notify so-called state trading enterprises (STEs) which are enterprises that "are granted exclusive or special rights or privileges". The Article disciplines cases where the level of purchases or sales conducted by STEs is not based on economic principles but rather on political considerations. The narrow definition of STEs (Box 3.4 means however that the Article may be of limited use when it comes to curbing anti-competitive actions of state enterprises seen more typically in global markets today (i.e. those that are influenced by the state but have not been granted exclusive or special rights or privileges).

In the area of services trade, the General Agreement on Trade in Services (GATS) mandates WTO member governments to progressively liberalize trade in services through successive rounds of negotiations. The GATS does not refer to state enterprises, state trading enterprises or state-owned enterprises explicitly, but contains two related concepts. Article I:3(b) of the GATS carves out from the scope of the Agreement "services provided in the exercise of governmental authority". These services are defined as services which are "supplied neither on a commercial basis nor in competition with one or more service suppliers". One interpretation of these provisions is that state enterprises, including SOEs, which supply services on a commercial basis or are competing with other service suppliers fall within the scope of the GATS and are subject to its disciplines. The GATS also contains disciplines regarding monopolies which apply to both public and private monopolies. Under the GATS Article XVIII, Members must ensure that monopoly suppliers act in a manner consistent with members' specific commitments, as well as with the MFN obligation.

Box 3.4. **Excerpts from the Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994**

Members,

Noting that Article XVII provides for obligations on Members in respect of the activities of the state trading enterprises referred to in paragraph 1 of Article XVII, which are required to be consistent with the general principles of non-discriminatory treatment prescribed in GATT 1994 for governmental measures affecting imports or exports by private traders;

Noting further that Members are subject to their GATT 1994 obligations in respect of those governmental measures affecting state trading enterprises;

Recognizing that this Understanding is without prejudice to the substantive disciplines prescribed in Article XVII;

Hereby agree as follows:

1. In order to ensure the transparency of the activities of state trading enterprises, Members shall notify such enterprises to the Council for Trade in Goods, for review by the working party to be set up under paragraph 5, in accordance with the following working definition:

"Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports."

This notification requirement does not apply to imports of products for immediate or ultimate consumption in governmental use or in use by an enterprise as specified above and not otherwise for resale or use in the production of goods for sale.

(…)

Source: Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994.

However, under the GATS, in addition to the so-called horizontal commitments, members undertake specific commitments by sector and by mode of supply. In sectors and modes where they undertake such commitments, members may protect national enterprises, including SOEs, in various ways. For instance, they can stipulate that the commitment will apply only to private entities. Alternatively, they may limit the number of service suppliers, refrain from granting national treatment or maintain some measures granting more favourable treatment to national entities. Some

additional rules relating to state enterprises have been added in selected existing PTAs.[39] In general, they build on and try to fill the gaps in the existing WTO rules by providing clearer definitions of state enterprises, more precise interpretations of certain related concepts (e.g. commercial considerations) and by including additional obligations, for example, on transparency and consultation. Naturally, these provisions reflect specificities and sensitivities of the signatory countries and can differ from one agreement to another. In NAFTA, US-Korea or Colombia-US FTAs, for example, state-owned enterprises are obliged by the same non-discriminatory obligations as the governments.[40] The US-Singapore FTA has additional transparency provisions, prohibits direct government influence on SOEs, collusion and other anti-competitive activities and foresees a progressive reduction in the number of Singapore's SOEs. The Singapore-Australia FTA also has extensive references to "competitive neutrality." Some PTAs contain provisions on services or the so-called "trade +" provisions on intellectual property rights, technical barriers to trade, or investment and competition, which may also be extended to state enterprises.

Currently, twelve countries—including countries with important state sectors such as Malaysia, Singapore or Viet Nam—are negotiating additional disciplines on state enterprises in on-going negotiations on the Trans-Pacific Partnership. While the final shape of new provisions is not yet known, state ownership and the concept of effective government control have been cited as a likely approach.[41]

Disciplines on state enterprises are also being discussed in the Transatlantic Trade and Investment Partnership between the US and the European Union which will involve several economies with important state sectors from both Western and Eastern Europe. When it comes to defining state enterprises, the EU's public initial proposal for legal text on state-owned enterprises[42] takes a broad approach and makes, among others, references to state ownership, voting rights that may be held by the state as well as to the ability of state to appoint members of administrative, supervisory and managerial boards. It also includes some of the terms used in the WTO, including "enterprises granted special and exclusive rights and privileges" as well as "commercial considerations" of state enterprises.[43]

3.4 Conclusions

Overall, while trade effects of state-owned enterprises remain an important policy issue, views on how to obtain a more level international playing field differ in practice. The opinions among policy makers and other practitioners differ on whether future policy responses should target specific

types of enterprises (e.g. SOEs) or whether they should cover a wider range of state enterprises and target specific behaviours (e.g. subsidies or preferential regulatory treatment). It is widely expected that this will become a topic addressed by plurilateral negotiations in the context of the WTO[44]. This suggests that further consideration of the definition of entities which should be the focus of guidance of disciplines would be an important area for further exploration.

Financial and regulatory support granted to SOEs (and private enterprises) are, from a trade policy perspective, the most often indicated concerns related to state influence on competition in international markets although the reported market effects are stronger for state firms (Kowalski, P and K. Perepechay, 2015). This implies that tightening of the WTO subsidy rules and further development of similar rules on regulatory advantages might be a useful across-the-board approach that could also alleviate some of the most pressing concerns related to state enterprises

Another important concern are the advantages granted by state enterprises to other firms through lower prices or better accessibility of inputs. This suggests that the issue of determining more clearly and predictably what kind of relationship with the government makes an enterprise susceptible to be considered as potential provider of a subsidy or another advantage—for example the definition of a "public body" in the context of the WTO—may be an important one to focus on in the future.

Even the most comprehensive rules may be worth little if they are difficult to enforce. WTO dispute settlement procedures can have diplomatic and commercial costs and might represent an uncomfortable forum for enforcement when the ultimate owners or supporters of state firms are closely affiliated to other government bodies which act, for example, as regulators or principals of government procurement biddings.[45] In this context, more effective enforcement might only materialise through sounder incentives for states and state firms to abide by market and transparency principles in the first place (Kowalski et. al., 2013). Interesting examples to follow here are some of the existing national investment policies and BITs, which on the one hand specify requirements with respect to behaviour of state investors, and on the other hand, offer access to investment markets and protection of investors' rights.[46] Thus, ultimately, a real strengthening of WTO rules on state involved firms—but also in other areas—in the future may require a resurrection of multilateral negotiations on trade, competition and investment (op. cit.).

Chapter 4

Competition law and policies applicable to state-owned enterprises[47]

The enforcement of competition law has been and continues to be an important lever in levelling the playing field in markets where SOEs and other market actors compete. This chapter looks at specific competition law approaches, drawing on case examples, applicable to the conduct of SOEs. It draws three main pillars: preventing the abuse of dominance, blocking or remedying anti-competitive mergers, and breaking up cartels. It also points to some challenges for competition enforcement where SOEs and cross-border transactions are concerned. It draws attention to additional levers, beyond competition enforcement that can serve to level the playing field. It points to advocacy; competitive neutrality; harmonized accountability and transparency requirements; and consistent application of rules concerning subsidies or state aid, as means to ensure that policies in one jurisdiction do not advertently or inadvertently impact the competitive environment in others.

The enforcement of competition law has been and continues to be an important lever in levelling the playing field in markets where SOEs and other market actors compete. The increasingly cross-border dimension of business activities (as demonstrated in the sheer rise in the number of global M&A deals), and the rise of SOEs as actors in the global marketplace has, however, created additional complexity for the effective and consistent enforcement of competition law. As a result of these cross-border transactions, competition authorities are confronted with the decision as to whether and how to respond to anti-competitive conduct that may span across jurisdictions; this may include evaluating the conduct of foreign SOEs (to the extent that the actions of such entities may have anti-competition effects). These developments have also resulted in increased the scope for cross-border investigation by competition authorities.[48] On the latter point, it is difficult to quantify exactly how many cases are taken up and by which competition authorities, let alone the number of cases involving state-owned enterprises. Yet, when one examines the number of deals involving the largest companies (see introductory section), it is well documented that state-owned enterprises are rising as key players – which may highlight the need for particular attention to how SOEs compete in the marketplace and for increased regulatory cooperation in cross-border contexts.

This chapter looks at concerns with regard to the competitive situation of SOEs from a competition perspective (section (a)); it further examines the tools, disciplines and standards that apply to SOEs, including potential concerns/shortcomings (section (b)); and, and it highlights particular challenges (for competition enforcement) that may be posed or exacerbated by foreign SOEs in our understanding and application of competition law which may have particular relevance in a cross-border context (section (c)). It concludes with some thoughts on areas of future (section (d)).

4.1. Concerns related to SOEs from a competition law perspective

The presence of SOEs in the marketplace is, in itself, not a reason for concern. There is no strong evidence that SOEs are more inclined to act anti-competitively than private enterprises. However, there may be some considerations specifically related to SOEs that can have an impact on competition and they are described as follows:

- *Commercial and non-commercial objectives of SOEs and impact on incentives to compete*. SOEs may not necessarily be profit maximising entities, but may pursue other non-commercial objectives which may provide incentives to expand its market share over competitors without

necessarily the aim of pursuing increased profits. SOEs may also have soft budget constraints (i.e. lower dividend expectations) or receive financing on preferential terms, which may affect their incentives to compete. If public sector businesses are *de facto* or *de jure* exempt from competition law or bankruptcy rules they may be able to engage in anti-competitive practices unchecked.

- *Entrenched positions*. SOEs may enjoy near-monopoly positions in newly liberalised markets and this may allow them to hold on to their market position through anti-competitive practices – such as blocking a competitor access to an essential input. This can result in raising a rivals' cost and erecting barriers to entry.

- *Subsidies and public services obligations*. SOEs may benefit from subsidies or a privileged position in the marketplace to carry out public service obligation. Competition concerns are often raised regarding the risk of cross-subsidisation between a privileged (or reserved) public activity and an economic activity. While cross-subsidisation may clearly distort the playing field (as an advantage or a disadvantage depending on the financing direction), it may not amount directly to a competition infringement (unless it results in predatory pricing, for example).

- *SOEs and industrial policy*. Relatively few OECD countries appear to be assigning a pro-active industrial policy role to their SOEs sectors – such as, for example, obligations to develop certain capabilities or pursue knowledge and technologies in the broader national interest. Conversely, the practice has remained commonplace in some emerging economies. This may have potential implications on the application of competition laws, if SOEs enjoy privileged treatment in order to meet the industrial objectives.

From a competition law perspective, should an SOE benefit from a privileged position in the marketplace (such as those described above or earlier in this paper), this might allow it to engage in anti-competitive conduct (i.e. abuse of dominance; cartels, or anti-competitive mergers). Some of the concerns, which can potentially be addressed through competition laws, are described below (this section draw from analysis in Capobianco and Christiansen, 2011)[49]:

- *Predation.* If SOEs are not subject to bankruptcy rules, or losses from commercial activities are bailed out by the State, SOEs are in a position to price below cost so as to exclude actual or potential competition. While this strategy may not necessarily be driven by the need to

increase profit but simply to maintain (or increase) the SOE market share (for example to maintain employment levels in a given sector) this has an impact on overall competition. Such predatory strategies have the effect of knocking-out competition. This type of behaviour can occur also through cross-subsidisation practices (from subsidised non-commercial activities to commercial ones).

- *Margin squeeze.* It is not uncommon for state-entrusted entities to be vertically integrated, enjoying a dominant position at an essential input or infrastructure level, and competing downstream for the provision of products or services. The risk of squeezing the margins of the downstream competitors by increasing their cost to accessing the upstream essential input/infrastructure may drive efficient competitors out of the downstream market. This can occur, for example, in liberalised network industries.

- *Raising rivals' costs and raising barriers to entry.* SOEs' strategies to raise rivals' costs can take a variety of forms. For example: incumbent can attempt to prevent rivals from gaining access to essential infrastructures or inputs or increase the market price of those inputs by purchasing excessive amounts of the input; confronted with new environmental regulations, incumbent companies can lobby hard to obtain grandfather clauses; incumbents may lobby the government to adopt restrictive regulation that would make entry into the market more costly, unprofitable or even impossible for new entrants; incumbents can tailor their product or service such that consumers cannot easily switch to a rival's product; or companies can vigorously pursue patent extension applications and one of the objectives of this behaviour could be to impose additional (litigation and other) costs on rivals to delay or thwart their entry.

- *Increased market power through anti-competitive merger.* Competition concerns may arise if a transaction is expected to increase market power resulting in higher prices (or in lower quality or less choice) for consumers; or if the transaction changes the nature of competition in such a way that firms will be significantly more likely to coordinate and raise prices or otherwise harm effective competition after the merger (in terms of lower product quality or less innovation). The increase of the number of transaction activity involving SOEs leads to increased scrutiny of SOEs M&A activities in domestic and international markets.

- *Price fixing, market allocation or output restrictions.* If SOEs have the power to set prices or other terms and conditions in their commercial

activities this could be of concern if it is found to constitute a cartel or other restrictive agreement. There is no evidence, however, that SOEs are more prone to collusion than privately-owned competitors.

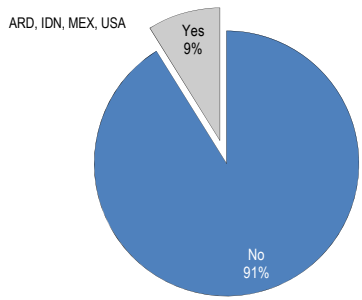
4.2. Addressing such concerns through competition law and policies

To address some of these concerns a number of tools, disciplines and standards can apply in the area of competition laws. This section examines the scope and application of competition law to state-owned enterprises (section 1); it further examines antitrust rules as a way to asses anti-competitive behaviour of SOEs (section 2); it examines specifically merger reviews (section 3); it moves then to non-enforcement power of competition authorities (section 4); to international enforcement co-operation (section 5); and, finally, discusses other tools/legal frameworks which may draw from or be based on competition law frameworks (section 6).

1) Scope and application of competition law

Subjective scope: Over the past decades, long strides have been made towards harmonising competition enforcement across jurisdictions, to strengthen enforcement and non-enforcement activities.[50] In most jurisdictions competition laws define their subjective scope as covering the conduct of any "person" or "undertaking", which are terms that have been generally interpreted broadly as encompassing any entity engaged in a commercial activity regardless of its ownership, its sources of financing, its legal status or nationality (see Figure 4.1)[51].

Figure 4.1. **Exemptions in application of competition law to SOEs are not common place**



Note: A yes indicates that some publically-controlled firms are subject to an exclusion or exemption, either complete or partial, from the application of the general competition law.

Source: OECD Database on National Practices and Regulations related to SOEs.

Material scope: Competition law only applies to an independent economic activity. Any activity which is mandated by law or regulation (e.g. a production quota system set-up by law) falls outside the material scope of competition law. Some jurisdictions, moreover, have adopted exclusion regimes barring the application of competition law to specific industry sectors or activities (i.e. in some jurisdictions this can include the provision of general public series, such as postal services, railways, healthcare, etc.).[52] An SOE's market activity can be caught under competition law if it amounts to a competition infringement, namely: i) an abuse of dominance; ii) a cartel or a restrictive agreement; or iii) an anticompetitive M&A.[53]

Geographic scope: A competition authority will assess the impact on competition on *relevant antitrust markets*. Relevant markets may be local, regional, national or international depending on the supply and demand dynamics of the product or service at stake.[54] A competition authority will generally be competent to examine any infringement or M&A that bear a link with, or has effects in, its jurisdiction, regardless of the nationality of the undertaking or SOE under scrutiny. While scrutiny will technically cover the effects on all relevant markets (even if they are broader than the territory of the agency's jurisdiction) in practice competition authorities tend to focus their analysis on domestic consumers. A separate but related issue is the ability of a competition authority to enforce its decisions in a foreign jurisdiction[55] or to reach out to entities or individuals located outside the jurisdiction and compel them to provide, for example, information useful to its investigation.

2) Antitrust enforcement as a way to assess anti-competitive behaviour of SOEs (abuse of dominance, cartels and restrictive agreements)

i. Abuse of Dominance

Despite liberalisation efforts, if former state monopolies may still enjoy dominant positions, privileged access to infrastructure and financing, its conduct can amount to abuses under competition law it (for example predation, or reducing a rivals' cost; or restricting access to an essential input). (For some examples of abuse of dominance cases involving SOE see Box 4.1)[56]:

Box 4.1. **Abuse of Dominance – Examples involving SOEs**

Deutsche Post. On March 2001, the European Commission issued its first Article 82 EC decision in the postal sector, finding that the German postal operator, Deutsche Post AG (DPAG), had abused its dominant position in the market for business parcel services by granting fidelity rebates and engaging in predatory pricing. DPAG was fined EUR 24 million in respect of the foreclosure resulting from its long-standing scheme of fidelity rebates. No fine was imposed in relation to predatory pricing given that the economic cost concepts used to identify predation were not sufficiently developed at the time. From the investigation, it transpired that DPAG was using revenues from the letter delivery monopoly to finance below-cost selling in the open market for business parcel services. The Commission decided that any service provided by the beneficiary of a monopoly in open competition has to cover at least the additional or incremental cost incurred in branching out into the competitive sector. Any cost coverage below this level is to be considered predatory pricing. The investigation revealed that DPAG, for a period of five years, did not cover the incremental costs for providing the mail-order delivery service. This decision was of a particular interest, as the European Commission considered that a derogation under the EC competition rules was not applicable because termination of the fidelity rebates and an increase in DPAG‟s price to cover at least the incremental cost of providing mail-order parcel services would not prevent DPAG from complying with its statutory obligation to perform a service of general economic interest („carrier of last resort‟).

US Postal Service. In the United States Postal Service v. Flamingo Industries,3 the Supreme Court of the United States was called to decide if the US Postal Service (USPS) enjoyed antitrust immunity. When the USPS decided to terminate a contract with Flamingo Industries, a supplier of mail-sacks, Flamingo sued in U.S. district court claiming that the Postal Service declared a “fake emergency in the supply of mail sacks” so it could give no-bid contracts to cheaper foreign manufacturers without allowing U.S. companies to compete for them. Flamingo claimed that with its behavior the USPS had sought to suppress competition and created a monopoly in mail sack production and that this violated federal antitrust laws (among other charges). The district court dismissed the antitrust claim reasoning that the federal government is protected by sovereign immunity. The Ninth Circuit Court of Appeals reversed on the antitrust immunity count. It ruled that the 1970 Postal Reorganization Act (PRA) waived the Postal Service’s sovereign immunity and that it could be sued under federal antitrust laws as a “person”. The Supreme Court ruled that USPS was not subject to antitrust liability. According to the Court, in both form and function, the USPS is not a separate antitrust person from the United States but is part of the government, and as such it is not controlled by the antitrust laws. Hence the Supreme Court concluded that, absent an express congressional statement that the Postal Service can be sued for antitrust violations despite its status as an independent establishment of the government, the PRA does not subject the Postal Service to antitrust liability. The Court found this conclusion consistent

Box 4.1. **Abuse of Dominance – Examples involving SOEs** *(cont.)*

with the nationwide, public responsibilities of the Postal Service, which has different goals from private corporations, the most important being that it does not seek profits. It also has broader obligations, including the provision of universal mail delivery and free mail delivery to certain classes of persons, and increased public responsibilities related to national 24 security. Finally, the Court found that the Postal Service has powers and characteristics which makes it more like a government than a private enterprise, including its state-conferred monopoly on mail delivery, the powers of eminent domain and the power to conclude international postal agreements.

Japan Post. The Japanese postal service has also been investigated for predatory pricing claims. In a private suit, both the Tokyo District Court and Tokyo High Court rejected the plaintiff's predatory pricing claim against Japan Post. The resolution of the case turned around the question of whether the plaintiff had brought sufficient evidence to prove its predatory pricing claim. As the Japan Fair Trade Commission ("JFTC") had not bought a case of its own first, the plaintiff could not obtain the necessary cost data from the defendant to prove its claim that Japan Post had priced its services below cost. This case is, however, interesting because the High Court argued that Japan Post's cost in commercial parcel delivery should not be calculated on a "stand-alone" basis (i.e., separately from the cost incurred for the provision of the regulated postal delivery). The Court argued that it is economically rational for an enterprise, when it enters into new business, to make use of its resources in its existing business. In 2006, the JFTC published a study group report, argued in it that a "standalone" approach should be used for allocating common fixed costs when a monopolist in market A entered market B. The Tokyo High Court in Yamato rejected the "standalone" cost method because it was not sufficiently established as a legal test.

Note: Other cases include European Commission COMP/39525 - *Telekomunikacja Polska*, COMP/40089 – *Deutsche Telekom*, COMP/39816 – *Gazprom;* US Supreme Court, *US Postal Service v. Flamingo Industries,* (US) LTD 540 U.S. 736 (2004); South Africa, *Competition Commission v. Telkom SA Ltd,* Case 11/CR/Feb04 and *Competition Commission v Telkom SA SOC Ltd* (016865) [2013] ZACT 62 (18 July 2013); and Chinese Taipei, Fair Trade Commission, *Taiwan International Ports Corporation (2014)* in Chinese Taipei's contribution to the OECD 2015 Roundtable on Competitive Neutrality.

Source: Derived from Capobianco and Christiansen, 2011.

In order to determine abuse of dominance, competition authorities may need to take into account certain considerations with regard to SOEs. For example, if the SOE carries out hybrid activities (i.e. public policy activities along with commercial ones), then some of the traditional competition tests (i.e. recoupment or cost benchmark) may prove to be challenging.

ii. Cartels and Restrictive Agreements

Restrictive agreements are anticompetitive and deemed "hard core" illegal when they entail price fixing, market allocation or output restrictions agreed upon among competitors, therefore harming competition and consumers. Hard core cartels are severely punished in all OECD member countries and in more than 100 jurisdictions around the world. One or more SOEs taking part in such agreement (within or across borders) may be subject to enforcement like any other cartel participant (For a recent example involving state-owned enterprises refer to the Box 4.2 below.). Cartel participants to be defined as "competitors" must be independent from one another. If several SOEs belonging to the same government were to enter into a restrictive agreement then the competition authority would have to determine whether they constitute a single entity or separate economic entities.[57]

Box 4.2. **Recent examples involving SOEs**

In July 2015 the European Commission has imposed fines on Express Interfracht, part of the Austrian railway incumbent Österreichische Bundesbahnen ("ÖBB"), and Schenker, part of the German railway incumbent Deutsche Bahn ("DB"), for operating a cartel in breach of EU antitrust rules in the market for so-called cargo 'blocktrain' services. Kühne+Nagel of Switzerland, which is one of the largest transport and logistics companies in Europe, also took part in the cartel. The three companies fixed prices and allocated customers for their "Balkantrain" and "Soptrain" services in Europe for nearly eight years. In order to limit competition between them, the companies agreed on several restrictive practices: they agreed and allocated existing and new customers as well as setting up a customer allocation scheme including a 'notification system' for new customers; they exchanged confidential information on specific customer requests; they shared transport volumes contracted by downstream customers; they coordinated prices directly by providing each other with cover bids in respect of customers protected under their customer allocation scheme and coordinated sales prices offered to downstream customers. The incumbents were fined as part of the Commission decision.

Source: European Commission Decision of 15.7.2015 CASE AT.40098 – Blocktrains.

One particular consideration to be made in relation to SOEs refers to the turnover that competition authorities should consider when determining the level of the fine for a cartel conduct. The general principle is that no distinction should be drawn between cases involving SOEs and private undertakings. However, in the case of SOEs, when applying turnover-based

rules to impose fines, the fine would be based on the SOE's turnover (value of sales) of goods and services to which the infringement directly or indirectly relates. For example, for the purpose of calculating the legal maximum sanction the European Commission normally uses the worldwide turnover of the highest incorporated legal entity which controlled (i.e. exercised decisive influence) over the infringing SOE. This may lead to the imposition of significant fines when an SOE is involved in a cartel case.[58]

3) Merger control and examples of merger scrutiny of SOEs across various jurisdictions

Competition authorities play an important role in reviewing the impact of mergers and acquisitions on competition and consumers. In all OECD member countries, large investments which allow the investor to acquire a controlling share in a company must be approved by the competition authority ex-ante, so that a successful approval process becomes a condition for the deal. In most OECD countries merger control rules are ownership neutral and equally apply to private as well as state-controlled investors. Mergers and acquisitions can include one or more SOEs, as merging, acquiring or acquired party. Acquisitions by foreign government-controlled entities are routinely subject to merger review.

Merger control consists in assessing the impact of mergers and acquisitions on competition, with a view to ensuring the competition process and innovation and to protect consumer welfare. The purpose of merger control is to identify and investigate competition-related concerns arising from M&A activities.

Most jurisdictions require that mergers or acquisitions above certain thresholds be notified for prior approval (or remedial action). Mergers that entail competition risks may lead to remedies addressing competition concerns, such as divestitures of part of the firms' business or behavioural obligations. It can also be prohibited by the reviewing competition authority(-ies). A merger generally must be notified in all jurisdictions where notification thresholds are met. Such thresholds are often based on the level and location of the turnover or assets or one or more of the merging parties. (OECD, 2015k)

A few specific questions, however, can arise as to the concrete application of usual merger control rules to SOEs, which may be particularly acute where the SOE is foreign and/or hybrid, i.e. carrying out both commercial activities and public services. This explains why specific rules have been adopted to account for the state ownership while ensuring the enforceability of merger control mechanisms in the EU area, for example, particular weight is placed on the notion of "independence" (see Box 4.3.[59] These considerations have further consequences when determining if the

notification thresholds are triggered; how to conduct an impact analysis of the merger; and if considered anti-competitive, how to determine remedies. The European Commission has examined a number of cases in which SOEs were considered. (See Box 4.5)

In Australia, the Australian Competition and Consumer Commission (ACCC) has adopted a "conservative and pragmatic" approach to assessing mergers involving SOEs, which also takes into consideration ownership and control (See Box 4.4).

Box 4.3. **EC merger rules: Application to SOEs**

Group turnover. When applying turnover-based rules in transactions involving a State or a SOE, account must be taken only of the turnover of the relevant economic unit with independent power of decision and of the undertakings for which the criteria in EU Merger Regulation Article 5(4) are met with respect to such economic unit. In order to determine which are the relevant economic units to take into account, the Commission follows a two-step approach:

- first, to establish whether the undertaking in question has an independent decision-making power concerning its commercial activities,
- if this is not the case, to determine which is the ultimate State entity which enjoys such independent decision-making power and which are the other undertakings controlled by this entity, whose turnover will have to be included in the calculation.

Control based rules. The mere fact that two or more undertakings are owned by the same State does not necessarily mean that they belong to the same group for the purposes of merger control. In order to determine whether an acquisition of control by a State-controlled company over another company owned by the same State constitutes a notifiable concentration or an internal restructuring, paragraph 52 of the Jurisdictional Notice establishes that "where both the acquiring and acquired undertakings are companies owned by the same State (or by the same public body or municipality) and forming part of different economic units having an independent power of decision, the acquisition of control of the latter by the former will be deemed to constitute a concentration". The same logic based on "independent decision-making power" and whether their commercial policies are determined independently will apply to control-based rules.

Source: European Commission submission to the Competition Committee (OECD, 2015f).

Box 4.4. **Merger scrutiny by Australia's ACCCs involving foreign SOEs**

In recent years in Australia, there has been considerable investment by foreign SOEs in mining assets and privatised infrastructure. In the case of an acquisition which involves a foreign SOE, the merger test is the same regardless of whether the entity is foreign or not. In many cases foreign direct investment is more likely to be pro-competitive for the market. However where a foreign SOE is acquiring an interest in Australia and there are related SOE owned horizontal or vertical interests that may impact on competition, the ACCC will consider the effect of this carefully. The ACCC takes a conservative and pragmatic approach in its consideration of the ownership and control arrangements by basing its competition analysis on the assumption that these related foreign SOEs are subsidiaries of the same parent entity and therefore may have common commercial incentives. If no competition concerns are raised based on this assumption, then it is not necessary to reach a view on the challenging control issue.

In the proposed acquisition of Rio Tinto by Chinalco, the ACCC considered whether the proposed transaction would likely affect iron ore prices by providing Chinalco with the ability and incentive to decrease iron ore prices below competitive levels to the benefit of Chinese steel mills. The ACCC ultimately concluded that Rio Tinto would not have the ability to unilaterally influence global iron ore prices to a significant extent. Therefore, the ACCC held that it was not necessary to evaluate whether the Chinese government, Chinese steel mills and Chinalco constituted a single entity.

Similar questions on whether related SOEs are independent have also arisen outside the merger area in the ACCC's consideration of an airline alliance where a rival airline to the alliance is also a related SOE to one of the alliance partners. While other factors mean that the question of whether or not the related SOEs were sufficiently independent was ultimately not determinative to the ACCC's draft decision, there is an increasing likelihood that the ACCC will encounter a merger or alliance decision where the level of related SOE independence will be critical to the assessment. This is likely to create a significant challenge in terms of obtaining the necessary information to thoroughly assess the level of independence and therefore the impact on competition.

Source: Australian submission to the Competition Committee (OECD, 2015e), Milhaupt and Zheng, 2015, and Cheng, et. al, 2014

Box 4.5. **Merger scrutiny of SOEs by the European Commission**

The Commission has reviewed a number of cases involving mergers of SOEs. Some of these are considered below:

Neste/IVO: In a 1998 anti-trust case which involved the merger of two Finnish SOEs, Neste and IVO, the European Commission acknowledged the structural link between the Finnish state and the SOEs; but the Commission found no indication that the commercial conduct of the two SOEs had been coordinated in the past. And it considered that they acted independently on the market as a result of being run by independently by their respective operating management.

EDF/Segebel: In a 2009 case, the Commission examined whether there was a risk of coordination between GDF Suez and EDF, both companies in which the French State has a significant shareholding interest. The Commission considered "whether the undertaking sets by itself its business plan, budget and strategy, in its own commercial interests, independently from other undertakings owned by the same state entity." In addition, the Commission took into account factors such as "the degree of interlocking directorships between entities owned by the same public unit or the existence of adequate safeguards ensuring that commercially sensitive information is not shared between such undertakings." Even though in both companies, the shareholding right was represented by the same ownership entity (APE), the Commission did not consider this to stand in the way of the companies to set their strategy independently; where “the powers are limited to the protection of interests analogous to those of a minority shareholder." The merger was approved.

SoFFin/Hypo Real Estate: In a 2009 case, which involved the nationalisation of financial institutions during the financial crisis, the Commission received a notification of a proposed concentration by which the Financial Market Stabilisation Fund ("SoFFin"), controlled by the Federal Republic of Germany, acquired the whole of Hypo Real Estate Holding AG ("HRE"). The Commission examined the control structure of these entities, which it found to be under supervision by the Federal Ministry of Finance (BMF). For the purposes of determining concentration, it considered other entities in the same sector also operating under the close supervision of BMF, even if managed under different departments.

China National Bluestar/Elkem: This recent case involved a Chinese SOE, a subsidiary of the SASAC-owned China National Chemical Corporation, which proposed to acquire a Norwegian silicon producer. When evaluating the competitive impact of the proposed transaction, the Commission determined that it was relevant to assess whether ChemChina is an independent economic entity, or whether it belongs to a wider economic entity, including those owned by the Chinese state active in the same markets. The investigation concluded that even if all SOEs under SASAC supervision were acting as a single entity, the proposed transaction would not lead to competition concerns. Therefore, the Commission avoided having to conclude definitively on the ultimate control of the parent company.

Source: Zhang (2014); also see European Commission submission to the Competition Committee (OECD, 2015f).

These cases may have an impact on the broader procedural and substantive assessment of mergers; and potentially the way SOEs can be considered under competition law in the future. Where particular concerns regarding the internationalisation of SOEs may take place, specific consideration may need to be placed on determining whether SOEs have incentives to coordinate their business activities for the purposes of maximising the benefits for the state. Although much weight is placed on corporate governance and independent management, so long as the effects on competition are not harmful, competition authorities are to some extent, neutral on these matters.

4) Non-enforcement powers

Enforcement powers of competition authorities are only one way to tackle anti-competitive state measures. Non-enforcement related powers can consist of a variety of activities to promote competition including (i) conducting market studies, (ii) exercising advocacy powers to limit public intervention (including subsidies and bailouts) to those areas where there are market failures or objectives of common interest, (iii) ensuring that regulatory interventions are not detrimental of competition, and, (iv) having some advisory or oversight role in public procurement processes. Advocacy can also extend to commenting on draft laws and even having the ability to challenge in acts and decisions of the public administration that might raise barriers to competition. These are mechanisms that some competition authorities have in their "toolbox" beyond enforcement. (For an example, see OECD, 2015h)

If the competitive distortions arise from a deliberate decision by a government to favour its businesses, then "advocacy" may be the most effective approach. Most competition agencies have the right, at their own discretion, to alert policy makers to the likely impact of their decisions on the competitive landscape. This process can also be used to generate a broader public awareness of a problem. Alternatively, if the competition distortions are the unintended consequences of other government policies, then transparency rules and specific competitive neutrality policies may be more effective (see below). Nearly all countries use advocacy, to some extent, to encourage efficient and fair competition between public and private sector businesses. However, it is not within the classic role of competition authorities to exercise these additional powers vis-à-vis foreign governments.

5) International enforcement co-operation

Because an increasing number of antitrust cases have a cross-border dimension, effective cooperation between competition authorities has

become increasingly important. Co-operation has also improved because of the increasing number of co-operation agreements between competition authorities. The 2014 *OECD Recommendation concerning International Cooperation on Competition Investigations* (Box 4.6) is an important step forward to address these challenges and to develop tools to assist authorities in their efforts to investigate cross-border anti-competitive practices or national anti-competitive practices for which the investigation requires access to information located in a foreign jurisdiction.

Box 4.6. **OECD 2014 Recommendation concerning International Co-operation on Competition Investigations and Proceedings**

The 2014 Recommendation concerning International Co-operation on Competition Investigations and Proceedings aim to promote effective and efficient co-operation among authorities and is an essential instrument to help OECD and non-OECD countries foster enforcement co-operation with other jurisdictions and deter anticompetitive practices and mergers with possible anticompetitive effects.

The 2014 Recommendation call for:

- Commitment to effective co-operation – It is important to minimise the impact of legislation that might restrict co-operation between competition authorities (such as legislation prohibiting domestic enterprises from co-operating in a proceeding conducted by other competition authorities).
- Adoption of national provisions that allow competition agencies to exchange confidential information without the need of seeking prior consent from the source of the information (so called "information gateways").
- Enhanced co-operation in the form of investigative assistance, including the possibility to execute dawn-raids (inspections of premises), requests of information, witness testimonies, etc. on behalf of another agency.
- Notifications of investigations - Technological advances and progress in transparency of competition authorities' activities required strengthened mechanisms of notifications and more flexible means, such as notification by email or by other electronic tools.
- Co-ordination of investigations - Parallel investigations against the same or related anticompetitive practice/merger demand that authorities co-ordinate their investigations or proceedings, for example, by aligning the timetables of the different investigations and discussing the competition authorities' respective analyses as well as the design/ implementation of competition remedies.

Source: (OECD, 2014d).

Some challenges related to cooperation may still arise, however. One *practical challenge* related to the case of an SOE may be a lack of transparency regarding costs of an SOE, or due to insufficient accounting practices. A more *political challenge* may be in lack of willingness to cooperate internationally. Still, as one authority reports, even if there is a lack of cooperation or information, this may not necessarily prevent an investigation from moving forward, nor prevent a competition authority from treating a SOE like any other company. (See Box 4.7 for an example)

Box 4.7. **Challenges related to international enforcement cooperation: European Commission**

The European Commission adopts a neutral position as to the ownership or "nationality" of companies involved in a merger, irrespective of whether they come from within or outside the EU. In 2012, the European Commission opened antitrust proceedings against Gazprom (in which the Russian government owns a 50.002% controlling stake) in relation to its alleged conduct in a number of central and eastern European gas markets. The opening of the proceedings was due to the Commission's concerns that Gazprom may have and may be abusing its dominant position in upstream gas supply markets in central and Eastern Europe, in some of which Gazprom is virtually the sole supplier. Following the opening of investigation by the Commission, the Russian government adopted a decree prohibiting Gazprom from replying to information requests issued by the Commission. This has however neither prevented the investigation from moving forward, nor prevented the Commission from treating SOEs like any other company and in this case from issuing a Statement of Objections. In September 2015, Gazprom has reportedly contacted the European Commission in view of moving towards a settlement.

Source: European Commission Submission to the Competition Committee (OECD, 2015f)and http://europa.eu/rapid/press-release_MEMO-15-4829_en.htm.

6) Competitive neutrality frameworks

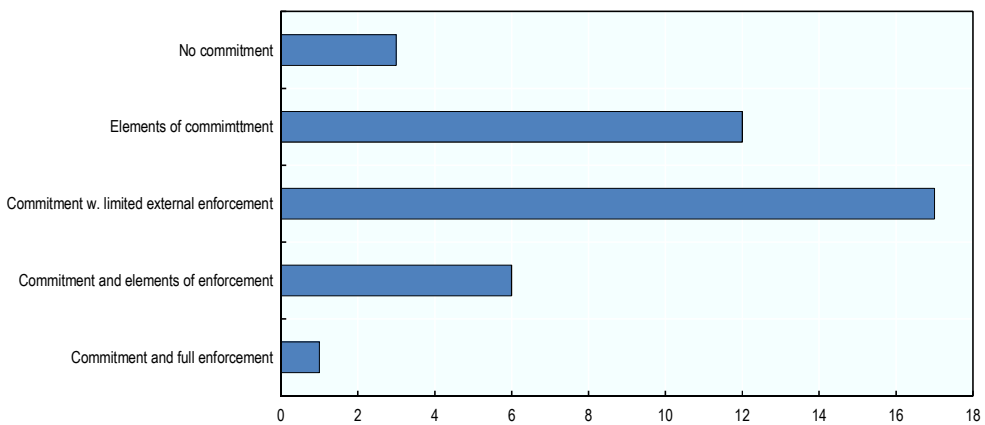
State presence in the market can lead to distortions of competition in various ways: through SOEs' differential treatment, but also distortionary regulation, subsidies, or *ad hoc* government intervention in private sector transactions on grounds of public or industrial policy, as examined in OECD (2015d). Where such distortions amount to competition law infringements, as seen above, they can be caught by competition enforcers. Otherwise, other means are needed to ensure a level playing field in the market, fall under the concept of "competitive neutrality" and need to be addressed through other tools and policies.

As Figure 4.2 demonstrates a small, but growing number of jurisdictions are enacting competitive neutrality commitments which address structural (economic regulation, etc.) and behavioural issues (corporate governance, state-ownership policy, etc.) regarding SOE conduct.[60] Competitive neutrality tools, such as subsidy control or regulatory impact assessment including neutrality principles, may be entrusted with competition authorities (i.e. some of the Scandinavian economies) or dedicated government bodies (Australian Productivity Commission), or a combination of the two. Other models, such as the EU State Aid regime, which ensures effective control of subsidies/State aid in the Single Market, falls somewhere in between.[61] For practical application of competitive neutrality frameworks to state-owned enterprises see also analysis and Boxes 5.2 and 5.3.

However, even when competitive neutrality policies exist; it should be noted that such policies are formulated with respect to domestic (state) entities and they do not shield countries from the effects of foreign state enterprises. For this reason, trade agreements are increasingly placing emphasis on mutual commitments to competitive neutrality. Indeed, the competitive position of SOEs even if restricted to operating at a national level, can have an impact on international trade and investment.

Figure 4.2. **Limited or no enforcement powers over competitive neutrality either by competition or other competent authorities**

(by number of respondent countries)



Source: Secretariat categorisation based on OECD (2012a) and OECD (2013c).

4.3. Challenges to the application of competition law to SOEs

The application of competition law does not distinguish generally between SOEs and other economic actors, or their nationality. However, as documented in OECD (2015d, 2013c and 2012a), there are still some challenges in the application of antitrust to state-owned enterprises, which can be further exacerbated when enforced against *foreign* SOEs or cross-border SOE activities. Some of these challenges relate to the enforcement of competition or institutional, substantive or conceptual challenges more generally; others relate to political or practical challenges.

Enforcement challenges/Institutional challenges: While the majority of competition authorities are independent in the way they run their investigative activities, it is theoretically possible that they could be exposed to the risk of undue government influence. If and when there is selective enforcement or lack of independence there is the risk of deepening market distortions by scrutinising some players only as opposed to others on mere grounds that the latter are state-backed for foreign government-owned although compete in the same field as private actors. (OECD, 2015i)[62]

In jurisdictions where the state grants concurrent review powers for mergers to both antitrust authorities (in charge of the merger review under competition standards) and sector regulators (in charge of reviewing the same transaction under other standards, e.g. a FDI review) a potential conflict between competition and other public policy goals may be exacerbated. Another problem may relate to the fact that competition authorities may lack sufficient statutory or power over SOEs, in particular, with respect to industries that are subject to oversight by sector regulatory agencies. If these regulatory bodies are weak, or if they confer special advantages to SOEs, competition authorities are not always able to tackle competitive distortions that result of this.

Conceptual/substantive challenges: In SOEs that carry out both commercial and non-commercial objectives, the application of traditional competition law standards, such as recoupment in predatory pricing may not be appropriate. These standards have been developed for profit maximising entities that may not necessarily be suited to SOEs which pursue multiple objectives. Moreover, it may be hard to determine whether SOEs are cross-subsiding, pricing at below competitive levels, or engaging in other anti-competitive conduct. Without a broader competitive neutrality commitment, some of these types of conduct may be hard to investigate prove or remedy.[63] This problem is further exacerbated by cross-border activities, when advantages in the home market may influence competitiveness abroad, but which do not result in any particular anti-competitive conduct, along the lines described above in section 2.

Where merger control is concerned, some governments, especially in emerging economies, have imposed that competition authorities take other "public interest" considerations into account in reviewing mergers (e.g. China and South Africa). For this reason, when an SOE is involved in a merger review, it may attract closer or more stringent scrutiny – so as to ensure other public policy goals (that SOEs presumably are entrusted with) are preserved (Cheng, et. al., 2014)).

Political/practical challenges: Some challenges are not directly related to the design of competition law itself, but to political considerations or practical obstacles when it relates to a foreign SOE. Some examples are provided below:

- If competition rules allow a competition authority to open an investigation into a foreign SOE's presumed abuse of dominance, the competition authority in charge may have difficulties obtaining relevant information from the foreign state owner. (See example above relating to international enforcement co-operation.)

- If the authority manages to prove the wrongdoing and impose sanctions accordingly, it may face hurdles (or be reluctant to) in enforcing the sentence against the foreign SOE or state owner. This would especially be true if the foreign state considers the actions of its SOE to fall under foreign sovereign immunity. In most jurisdictions, however, where the conduct of an SOE is commercial in nature, the immunity does not apply. (Gaukrodger, 2010)

- If a foreign SOE's conduct is considered anti-competitive, the penalty and remedies that the recipient country authority can impose on the subsidised foreign firm may not have any deterrent effect on the SOE.

- SOEs may be subject to competition law, but the law they are subject to does not necessarily prevent subsidisation or other privileges granted to the state's own enterprises. Thus these areas of potential concern (as highlighted earlier in this paper) would not come under the purview of a competition investigation. As pointed out in OECD, 2015j, since there is no common definition for what constitutes a subsidy across competition authorities, it is increasingly difficult to analyse empirically to what extent a specific subsidy or other form of state intervention/advantage may be the source of anti-competitive conduct.

- In some jurisdictions, weak rule of law, and especially a lack of judicial independence can create problems in ensuring effective enforcement. For example, courts may not align with competition authorities and annul sanctions imposed on SOEs or SOE officials. (OECD, 2015g)

4.4. Conclusions

Competition law offers a wide range of tools/disciplines that can be an effective way to prevent/remedy anti-competitive conduct by state-owned enterprises. Competition authorities are principally concerned that competition generates significant benefits by enhancing consumer welfare through the provision of better products and services at a lower cost. Governments play a role in promoting competition through the use of a variety of policies; including economic regulation, trade policy and competition enforcement. As a result, some of the policies may share the same objectives to achieve greater competition; whereas others may promote other objectives. These instruments may not always be in line with competition policy; but are desired for public policy purposes (i.e. industrial policy).

This has a number of implications. If various jurisdictions place other objectives ahead of those trying to be achieved by competition laws, so long as any resulting distortions remain limited to the domestic marketplace, then it falls within a country's sovereign right to regulate (even if not desirable from an economic efficiency perspective). Furthermore, even nationally operating SOEs can distort international trade and investment. Indeed, in an increasingly global economy the geographic boundaries of many markets extend beyond one country's borders. Therefore, the risks that the effects of companies' behaviour spill over in other jurisdictions raise serious challenges to the current enforcement system.

Comity and reciprocal commitments – such as increased harmonization of competition policies, and broader commitments to competitive neutrality, more harmonized accountability and transparency requirements, and more consistent rules concerning subsidies or state aid – may be necessary to ensure that policies in one jurisdiction do not advertently or inadvertently impact the competitive environment in others.

As the volume of cross-border transactions continues to rise, the complexity faced by competition agencies (and other enforcement agencies) in obtaining information and evidence located outside their jurisdiction and in enforcing their decisions against foreign companies is increasing. As such regulatory and enforcement co-operation is key to ensure that investigations, including those involving state-owned enterprises, can be effectively addressed by the competent authorities.

Chapter 5

The ownership and governance of state-owned enterprises [64]

Governments acting as the owners of enterprises engaging in cross-border trade and investment face a number of issues regarding their ownership and governance structure. This chapter covers the main areas of concern for the government as an owner; and concerns for regulators and policy makers in foreign jurisdictions. It points to examples of the actions taken, at the national as well as international level, to address some of the concerns. These include adhering to codes of corporate governance and competitive neutrality arrangements. The chapter also extensively covers provisions of the OECD Guidelines on Corporate Governance of State-Owned Enterprises that are applicable to SOEs operating across borders. The Guidelines promote the clarification of SOE objectives; sound regulation and governance practices; the independence and autonomy of SOEs; and better monitoring through strengthened transparency and disclosure, as priority areas to focus on.

5.1. Concerns related to internationalisation of SOEs from a corporate governance perspective

Governments acting as the owners of enterprises engaging in cross-border trade and investment face a number of issues regarding their ownership and governance structure. Most of these are not formally linked to cross-border operations but can be exacerbated by the fact that SOEs operate in multiple jurisdictions and at a distance from their headquarters. The issues fall into two broad categories, namely (1) areas of concern for the government as an owner with respect to the financial and reputational cost of its SOEs operating abroad; (2) areas of concern for regulators and policy makers in foreign jurisdictions that the SOE owners may wish to address through their ownership and governance practices. The two topics are discussed separately in the following sub-sections.

1) Areas of direct concern for the ownership function

A crucial balancing act for those exercising the ownership of SOEs is ensuring that the enterprises enjoy sufficient autonomy to act as efficient corporate operators, while at the same time ensuring that they do not operate out-of-control by imposing enforceable financial and non-financial objectives on the SOEs and their boards of directors. The latter is closely related to one of the classic "agency problems" of corporate governance - namely how to ensure that the corporate management is aligned with the interest of the ownership. It not specific to SOEs, but it may in some circumstances give rise to exacerbated concerns when SOEs operate internationally. This and other issues for the government owner are discussed as follows.

- *The risk of over extending.* In the case of foreign direct investment, in particular, there is a risk that SOEs expand abroad beyond what is in the interest of their domestic constituency and the public officials exercising the ownership function. This is principally facilitated by the "soft budget constraint" that many SOEs face in the form of either explicit government guarantees (increasingly rare), implicit guarantees or the mere perception of implicit guarantees that induce commercial lending to finance SOE expansion on favourable terms. An interview-based review of the experiences with SOEs operating abroad noted that SOE managers can be extremely "aggressive" in their planning (OECD, 2010b).[65] In addition to the sometimes easier access to financing this can also reflect managerial incentives. The foreign expansion by SOEs domiciled in OECD countries has often been undertaken by companies located in recently liberalised sectors (e.g. in the network industries) where they continue to enjoy a dominant position

in their domestic markets. Expanding abroad is often formally justified in terms of risk diversification or as attempts to gain a strong footprint in markets where the expertise that the investing SOE embodies is still in short supply. However, SOE managers in these sectors are sometimes beholden to problems of moral hazard, and may pursue riskier transactions which in the – subjective – words of a representative of one state ownership function, often emanates from "perceiving an unfulfilled potential", which may account for a personal motivation to seek challenges abroad.

- *Risk management.* Most cases of corporate failure (and scandals) have as one of their root causes a failure of risk management. In an ex-post analysis of the 2008 financial crisis the OECD (under the auspices of the Corporate Governance Committee) concluded that an imperfect understanding of risk at the level of corporate boards of directors, the body formally in charge of risk management in most jurisdictions, was probably the single largest contributing factor to the corporate failures that took place at the time (OECD, 2014a) http://www2.oecd.org/oecdinfo/info.aspx?app=OLIScoteEN&Ref=DAF/CA/CG(2009)3. This finding is obviously not limited to SOEs, but there are some relevant points of comparison. Many of the financial institutions affected by the financial crisis were found to have "weak boards", which included individuals which on the one hand lacked essential corporate skills, and on the other hand often felt beholden to the CEO who had been instrumental in their appointment. SOEs without proper board selection structures are at risk of finding themselves in an observationally similar situation if, for example, they are political appointees without corporate expertise and/or the top management is appointed directly by the government and the board has little power to carry out its supervisory functions[66]. The problem can be further compounded by operations in foreign jurisdictions. Investing in assets, or trading in foreign jurisdictions, that may be less well understood than the domestic reality carry obvious risks, and to this should be added the extra risks to legal and regulatory compliance that arise from operating across jurisdictions. For example, a recent study by the OECD documented that SOEs are disproportionally at risk of becoming embroiled in international corruption investigations[67]

- *Disclosure and transparency*. Distance in itself may complicate the compilation and dissemination of information, and this problem is compounded by legal and institutional differences among jurisdictions. Again, this challenge is not limited to SOEs, but it may felt more acutely in the case of state ownership. For example, in many OECD countries

governments require SOEs to report according to best practices applied to stock-market listed enterprises (e.g. demanding IFRS or US GAAP accounting). If the SOEs acquire or establish a corporate presence in jurisdictions with more lenient reporting requirements issues of compatibility arise and there may be a risk of slippage of standards for the SOE group as a whole. Moreover, SOEs are often required to engage in non-financial reporting over and above what is required of private sector enterprises, including, but not limited to, the state's expectation of their fulfilment of the public service requirements they are expected to pursue. Experience shows that this can be significantly more complex task when a company operates in multiple jurisdictions and subject to different sets of public perceptions and expectations of the corporate sector.

- *Corporate responsibility.* Closely related to the previous two points, SOEs are often expected to operate according to particularly high standards of corporate responsibility[68]. Whereas the shareholders of a private company may decide to disregard public opinion and content themselves to be operating inside the law, SOE ownership can generally not avail itself of this option. If certain corporate practices are deemed unacceptable by the public and press, political accountability would normally imply that companies owned by the state will be actively discouraged from pursuing them. These challenges can be further strengthened when SOEs operate abroad. In the presence of different legal and ethical frameworks the domestic public may nevertheless expect a conduct throughout an SOE's value chain that is consistent with the values in its home country. This issue comes to the forefront when SOEs operate abroad in so-called "weak governance zones" (where certain labour, health, environmental or other standards may be lower or weakly enforced). Even when all the countries of operation are generally considered as operating at high standards of corporate responsibility, issues can arise vis-à-vis the expectations for a state-owned company as portrayed in the public and press.

An example of foreign investments by an SOE in the power generation sector which arguably exemplifies several of the concerns suggested in this section is provided in Box 5.1. It should, however, be noted that the information relies entirely on news reporting that has not been verified by the authors of this report. It is provided purely illustrative purposes.

Box 5.1. **Swedish example of foreign investment by an SOE**

Vattenfall was founded in 1909 as a state-owned enterprise in Sweden. From its founding until the mid-1970s, Vattenfall's business was largely restricted to Sweden, with a focus on hydroelectric power generation. In 1974 the company began to build nuclear reactors in Sweden, eventually owning seven of Sweden's 12 reactors. In 1992, Vattenfall was reformed as the limited liability company Vattenfall AB.

In the years 1990 through 2009, Vattenfall expanded considerably (especially into Germany, Poland and the Netherlands), acquiring stakes in Hämeen Sähkö (1996), HEW (1999, 25.1% stake from the city of Hamburg), the Polish heat production company EW (2000, 55% stake), Elsam A/S (2005, 35.3% stake), and Nuon (2009, 49% stake). In 2002 Vattenfall AB and its acquisitions were incorporated as Vattenfall Europe AG, making it the third-largest electricity producer in Germany.

Following the expansion period, Vattenfall started to divest parts of its business in Denmark and Poland during the years following 2009 in a strategy to focus on three core markets: Sweden, Netherlands, and Germany. Write-downs on coal-fired and nuclear power plant assets in Germany and gas power plants in the Netherlands were necessary in a difficult market environment with increasing renewable energy market share and due to the German Nuclear power phase-out decision of 2011. In summer 2013 Vattenfall announced a write-down off the value of its assets by 29.7 billion SEK (4.6 billion USD). A major part of these write-offs were attributed to Nuon Energy NV, a Netherlands-based utility that Vattenfall purchased at a 97 billion SEK (ca. 15 billion USD) price in 2009, but whose values was depreciating by 15 billion SEK (ca. 2 billion USD) since.

The unfavourable market outlook of decreasing power prices in combination with increasing risks notably on the continental market (which affected a number of competitors similarly69) prompted the board to revise the group strategy by splitting its organizational structure into a Nordic part and a part with operations in continental Europe and the United Kingdom as of 2014. In this context and in response to a local referendum in Hamburg on re-municipilisation of distribution grids, Vattenfall agreed on the sale of company-owned electricity and district-heat grids in this area to the City of Hamburg in early 2014.

The expansion by Vattenfall in neighbouring countries has been subject to occasional criticism by the Swedish public and press, as well as non-governmental organisations in a number of countries. One contested issue is the fact that highly leveraged takeovers have created a fiscal risk for the Swedish government, which is compounded by the contingent liabilities arising from future decommissioning costs of ageing power stations.

Environmental organisations have moreover complained that Vattenfall's expansion strategy has involved the acquisition of multiple brown coal-fired power plants. This has been controversial in Sweden and Germany due to this is among the most polluting forms of electricity generation, and has been perceived by some as contradictory to the “green” self-image that the Swedish parent company tends to paint of itself.

Source: Authors based on various news articles. It should be noted that more recently, in 2015, additional writes-offs, amounting to losses of 3 billion USD, have been necessitated due to falling values of its nuclear and coal assets.

Another kind of challenge posed by the "internationalisation" of markets in which SOEs operate can also occur when foreign private enterprises penetrate the domestic markets of the state-owned operators. This may, for example, occur where the SOE is a former monopoly that has been exposed to competition through deregulation, as illustrated in the case of the opening of the European utilities sectors in the context of the EU Single Market. A main challenge for the ownership of SOEs in this case is obviously to ensure that the enterprises they control are operated efficiently so that they remain commercially viable. During the transitory phases this may be complicated, *inter alia* because of stakeholder issues such as: (1) the employment conditions for SOE staff that may previously have benefited from special employment and pension arrangements; and (2) a need to review a number of public service obligations that, in their previous form, are not suited for the new competitive environment. In the longer run issues of legal and regulatory compliance may arise. One example touched upon in the previous section, relates to competition between the SOEs and the new market entrants. Several studies have demonstrated that previous monopolies continue to enjoy considerable "incumbency advantages", which may not amount to abuse of market position in the strict sense of competition law[70]. If the national authorities are committed to maintaining a sound competitive environment they may need to intervene directly in their capacity of enterprise owners. This is discussed further in a following section on safeguarding a level playing field.

In addition to the issues listed above, those exercising the ownership function of SOEs need to consider whether in a situation they decide to trade or invest abroad they would be welcomed into foreign jurisdictions. The outcomes of a perception based study conducted by the OECD (see also Chapter 1) indicates that this is sometimes, but not usually, of concern to the SOE owners (Sultan Balbuena, 2016). Some of the main reasons why this situation may arise are discussed in the following section.

2) Concerns arising in partner countries

A number of policy and regulatory communities have in the past pointed to the fact that a majority of the concerns that commentators and regulators harbour about SOEs' behaviour in the marketplace could probably be overcome if the owners of the SOEs were adhering to internationally accepted good practices of ownership and governance[71]. In an international context, the implication is that many of the issues for foreign trade, investment and competition regulators discussed in the previous sections could also be assuaged through adequate and timely action by those exercising the ownership rights in state-owned enterprises. Some of the areas meriting special attention are:

- *The autonomy and independence of SOEs.* Just like the state's ownership of enterprises, as discussed in the previous section, can be too hands-off (leading to agency problems) there is a risk of going too far in the opposite direction. If the state intervenes frequently and/or on an ad-hoc basis in the managerial and board functions of SOEs then those SOEs effectively become agents of the state rather than autonomous corporate entities. From a corporate and public governance perspective this is suboptimal because such functions can be more efficiently conducted through institutions with a different legal and institutional structure. From the perspective of foreign trade and investment partners this is a source of concern because it implies that they effectively have a foreign sovereign power acting in their marketplace. It can further complicate matters under a merger review for what concerns the "single entity theory". This does not imply that the state shouldn't act as an active and engaged owner of its SOEs, but it means that it should grant them a mandate and sufficient day-to-day autonomy to ensure foreign regulators that they act in pursuit of commercial rather than political objectives.

- *The state's role as an owner and regulator of enterprises.* Related to the previous point, it is important that foreign policy makers and regulators may ensure themselves that the state's respective roles as an enterprise owner and regulator (including with respect to competition and sector-specific regulation) are conducted separately. This is considered a good practice even where SOEs are fully domestic since the interest of enterprise owners and regulators inevitably sometimes are in conflict. It gains added importance when SOEs operate internationally. First, the exercise of regulatory powers may in some cases be a close substitute to intervention in the managerial function as described above. This is for instance the case where SOEs operate with a dominant position in their domestic markets, so that "ownership neutral" market regulation in reality takes direct aim at certain SOEs. Secondly, as alluded to in previous chapters, authorities in the foreign jurisdictions in which SOEs operate often have little option for obtaining information about, and influencing the actions of, these SOEs than regulatory cooperation by their home jurisdictions. If the home country regulators are essentially the same public bodies that act as the owners of the enterprises then this is likely be a source of concern and potential conflict with the foreign regulators.

- *The nature and extent of public policy objectives.* As mentioned earlier there is nothing onerous about an SOE being charged with certain tasks that go beyond what a private enterprise would do in like circumstances – and indeed "public policy objectives" are usually a main reason why

policy makers consider that a given company should remain in public ownership. In OECD countries such objectives often relate to the provision of public services in a non-discriminatory and affordable fashion, or to the SOE being charged with remedying certain market imperfections. In emerging economies, as mentioned in the introductory section, SOEs are sometimes charged with the pursuit of elements of national development strategies and/or the conduct of industrial policy. In the case of cross-border operations of SOEs the question arises whether public policy objectives effectively "stop at the border" or are carried into foreign jurisdictions. The most clear-cut example of cross-border implications obviously arises when public policy obligations specifically include a duty to expand internationally. Such cases are rare, although the Chinese "go out policy" initiated in 1999 is often cited as an example. However, observationally equivalent cases arise where governments, in accordance with textbook economics, seek to compensate their SOEs for demonstrated market failures. In sectors with significant economies of scale this creates a strong "domestic case" for compensating small or newly established SOEs through subsidies or other preferential treatment. However, as most of these SOEs' competitors are found in foreign jurisdictions trade and investment related frictions are likely to arise. An example of this is the recurrent controversy that has arisen over emerging economies' attempts to create internationally competitive state-owned airlines.

- *Disclosure and transparency.* As exemplified by this report and the outcomes of the questionnaire-based exercise a key issue for foreign policy makers and regulators is a lack of knowledge about any given foreign SOE trading partner or investor. More often than not concerns arise from a lack of understanding about the objectives and operations of the foreign SOE rather than from a positive knowledge of concrete risks. It is therefore in the interest of SOE owners to disclose as much information as is possible without compromising essential corporate confidentiality. This goes well beyond financial reporting to include information about ultimate beneficiary ownership and control, corporate organisation, commercial and non-commercial priorities, as well as relationship with stakeholders and related parties. In actual practice, however, some difficulties may arise from the fact that national standards for disclosure of financial and non-financial information (including by, but not limited to, state-owned enterprises) differ significantly across jurisdictions. This problem can be further compounded where SOEs are held closely to the general government sector and may, within some systems of public governance, be subject to relatively extensive confidentiality requirements.

- *Competitive advantages arising out of state-ownership*. Whether or not a reality, regulators may be wary of trade or investment by SOEs, based on a presumption that the SOEs are subsidised by their government owners or enjoy other tangible or intangible benefits. In a number of cases these benefits are intended to compensate the SOEs for public policy objectives. In some countries (including, but not limited to, emerging economies) particularly thorny issues may arise because SOEs carry "implicit public policy objectives" – such as acting as an employer of last resort in economically depressed areas – which would render them financially inviable if they were to operate entirely under market conditions (even if counter to economic efficiency arguments). In a purely domestic context the costs of such measures are borne by the same constituency which is the intended beneficiary, so if adequate transparency and accountability mechanisms are in place no controversy need arise – unless of course such measures have an impact on markets which often extend much beyond geographic borders. However, such benefits may also amount to explicit or implicit guarantees, outright subsidies, lower rates of return on investments (or lower dividend expectations), cross-subsidisation from non-commercial to commercial activities, and more. However, if SOEs expand across borders their owners may face pressures to ensure that any public policy objectives are compensated accurately (neither too little nor too much); and that their presence in foreign jurisdictions does not have adverse effects on the competitive landscape of other jurisdictions. This is conceptually linked to the challenge of maintaining competitive neutrality which is developed in the following sub-section.

3) Competitive neutrality: maintaining a level playing field

The maintenance of a level playing field between SOEs and private enterprises is commonly referred to as "competitive neutrality". The first comprehensive review by OECD of this issue in a transnational context undertaken in 2010-2011 proposed the following broad definition: "competitive neutrality occurs when no entity operating in an economic market is subject to undue competitive advantages or disadvantages"[72]. In the context of present report the scope would have to be advantages (or disadvantages) obtained in consequence of state ownership, and the economic market refers to the international marketplace.

Governments may decide to depart from competitive neutrality – for instance where SOEs are used as vehicles for developmental strategies that may involve the superimposition of policy priority over market mechanisms. If, moreover, they make a conscious decision to support the activities of their SOEs' operations abroad (effectively departing from the above

considerations about limiting public policy objectives to the domestic context) then the discussion about ensuring competitive neutrality is essentially moot. However, concerns about competitive neutrality also arise when SOEs operating in the international marketplace are subject to public policy objectives in their domestic constituency. In a cross-border context the challenge for policy makers and regulators is then to ensure that distortions of the competitive landscape do not occur, or, to the extent that they occur that their effects on competition are not harmful in the marketplace in question. In the case of internationalisation of SOEs this may imply limited harmful effects to their domestic marketplace, but in the case where this effectively precludes foreign entry in the domestic market important additional concerns arise.

Ongoing negotiations of international trade and investment treaties have grappled with the role of SOEs, and one of the topics for discussion has reportedly been whether it would make sense to aim for broad neutrality commitments. At issue is first and foremost the difficulty in assessing and regulating tangible and intangible advantages that an internationally active SOE may enjoy. In this context, again, the above point about transparency of the state sector has been one of the central points of discussion. Box 5.2 provides an overview of the main challenges that must be overcome for SOEs to be operating in a verifiably competitively neutral fashion.

Considering the very broad set of issues at stake it must be recognised that competitive neutrality is difficult to maintain in the international marketplace unless the participating countries engage in a concurrent commitment to enforcing it at home. Theoretically the owners of SOEs could of course commit to operating abroad only through separate corporate units (which is essentially an "internationalisation" of the first point made in Box 5.2), but in practice this would compromise the operational efficiency of many SOEs. Absent this option, many potential SOE advantages are "inherently domestic" including a privileged market position, regulatory forbearance, privileged access to public procurement, etc., which can realistically only be addressed by a full commitment from those who exercise the ownership function over these enterprises and by addressing the regulatory environment in which SOEs operate.

Box 5.2. **Maintaining a level playing field: Main "building blocks" in competitive neutrality**

According to an evolving consensus, at the OECD and elsewhere, governments wishing to obtain and enforce competitive neutrality need to focus attention on the following seven priority areas:

- *Streamline government businesses either in terms of corporate form or the organisation of value chains*. An important question when addressing competitive neutrality is the degree of corporatisation of government business activities and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for commercial activities to operate in a market-consistent way. Incorporating public entities having a commercial activity and operating in competitive, open markets, as separate legal entities enhances transparency.

- *Ensure transparency and disclosure around cost allocation*. Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). For unincorporated entities, problems arise where they provide services in the public interest as well as commercial activities from a joint institutional platform.

- *Devise methods to calculate a market-consistent rate of return on business activities.* Achieving a commercial rate of return is an important aspect in ensuring that government business activities are operating like comparable businesses. If SOEs operating in a commercial and competitive environment do not have to earn returns at market consistent rates then an inefficient producer may appear cheaper to customers than an efficient one.

- *Ensure transparent and adequate compensation for public policy obligations.* Competitive neutrality concerns often arise when public policy priorities are imposed on public entities which also operate in the marketplace. It is important to ensure that concerned entities be adequately compensated for any non-commercial requirements on the basis of the additional cost that these requirements impose.

- *Ensure that government businesses operate in the same or similar tax and regulatory environments*. To ensure competitive neutrality government businesses should operate, to the largest extent feasible, in the same or similar tax and regulatory environment as private enterprises. Where government businesses are incorporated according to ordinary company law, tax and regulatory treatment is usually similar or equal to private businesses.

Box 5.2. **Maintaining a level playing field: Main "building blocks" in competitive neutrality** *(cont.)*

- *Debt neutrality remains an important area to tackle if the playing field is to be levelled. The* need to avoid concessionary financing of SOEs is commonly accepted since most policy makers recognise the importance of subjecting state-owned businesses to financial market disciplines. However, many government businesses continue to benefit from preferential access to finance in the market due to their explicit or perceived government-backing.
- *Promote competitive and non-discriminatory public procurement.* The basic criteria for public procurement practices to support competitive neutrality are: (1) they should be competitive and non-discriminatory; and (2) all public entities allowed to participate in the bidding contest should operate subject to the above standards of competitive neutrality.

Source: OECD (2012a), Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business.

A top priority for SOE owners in ensuring competitive neutrality relates to the design of the compensation for any public policy obligations. To ensure neutrality they must be calibrated carefully to cover the (marginal) costs of undertaking the additional obligations. In practice, however, this implies the disbursement of a well-defined subsidy – either as a cash grant or, if the SOE is profitable, by the government agreeing to forego a predefined amount of dividend payments. This is not always politically feasible, and those exercising the ownership function often find themselves compensating SOEs through other concessionary treatments such as cheap funding or by accepting an artificially low rate-of-return on the equity invested in the SOEs. Such advantages tend to be proportional with the business volume of the SOEs rather than with the cost of their public policy obligations. They can be calibrated to provide adequate compensation when the owners are able to assess up-front the approximate extent of the SOEs' business volume in the coming period of operations. When SOEs expand abroad the ownership function will need to assess quickly whether and how the institutional arrangements surrounding, and compensation for, the public policy obligations need to be adjusted, so as to ensure that subsidised public policy objectives are not used to support commercial activities.

5.2. Corporate governance tools, disciplines and standards to address such concerns

The chapters addressing trade, investment and competition issues arising from the internationalisation of SOEs have identified a number of issues that can be addressed only by, or with the cooperation of, the ownership function of those SOEs. The previous sections of the present chapter have analysed how these challenges present themselves from perspective of the owners. This section reviews examples of the actions that policy makers have taken, at the national as well as international level, to address some of the issues.

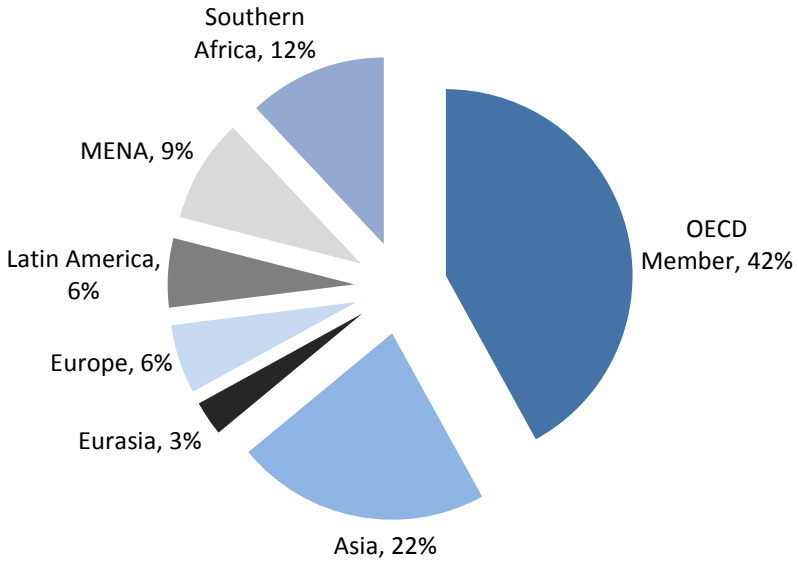
1) National rules, regulations and policy decisions

i) Corporate governance codes for SOEs

State-owned enterprises are obviously required to comply with applicable legislation, which according to national context may include general company law, laws bearing on the SOE sector or, in the case of statutory corporations, company-specific legislation. Such laws normally set minimum standards for corporate reporting and certain other aspects of corporate governance, but fall short of addressing the multitude of issues identified above. In addition to applicable laws and regulations a number of governments have therefore developed "SOE codes" laying down the expectations that the government as an owners has of its SOEs and, in many cases, also specifying how the state shall exercise its ownership rights. A recent study of the OECD identified (Figure 5.1) 33 of such codes (OECD, 2016b).[73] [74]

In terms of their scope of focus, most codes haven been recently adopted (post-2005) and are non-binding.[75] [76] The Codes are addressed to SOE shareholder ministries or agencies and/or to State representatives sitting on SOE boards of directors.[77] This is illustrated further in section B, below, which includes a broad assessment of the SOE corporate governance codes' general alignment with the OECD SO Guidelines' overall recommendations. A smaller number of the codes also employ the code as an instrument for expressing elements of the rationale for state enterprise ownership.

Figure 5.1. **Regional breakdown: SOE codes of corporate governance**



Note: The regions Asia, Europe and Latin America include only countries that are not members of OECD.

The vast majority of codes included here were adopted after the OECD SOE Guidelines, and more than half explicitly mention the OECD corporate governance instruments. It is not surprising, therefore, that all of the SOE corporate governance codes include some of OECD's key recommendations. The areas covered by national SOE codes that are of particular relevance to the present report are the following:

- A majority of the codes (55%) request the identification and/or communication of *public service obligations* and other non-commercial responsibilities by SOEs.
- A significant minority (24% and 30% respectively) address the issues of *separating regulatory functions from the exercise of ownership* and the *applicability of all relevant laws and regulations* to SOEs. (Moreover, some of the codes that did not address these issues presumably omitted this because it was already covered by legislative acts.)
- A large majority of the surveyed codes (73%) contained specific provisions clarifying *how the state shall exercise its ownership rights*,

including in many cases establishing a rationale for state ownership of enterprises.

- As regards transparency, a majority of the codes (58%) establish requirements for the *disclosure of material information*, which mostly specify the type and amount of information to be disclosed, as well as in some cases lay down criteria for "materiality". In addition, close to half of the codes set out requirements regarding *internal and/or independent external audits*.

- Relatively fewer codes (30%) establish a requirement for the state to engage in aggregate annual reporting regarding its SOE portfolio. However, in actual practice an independent stock-taking (a report on which is forthcoming) has established that 60% of OECD's member countries –engage in some form of aggregate reporting either for all SOEs, a select portfolio of SOEs, or through an online inventory leading to financial statements and annual reports for SOEs.

In addition to the issues identified by this chapter, and related to the broader issue of good SOE governance, national SOE codes provide extensive recommendations regarding SOEs' boards of directors. These include board mandates (79%), annual evaluation (76%), board composition, including with regard to independent directors (69%), remuneration (55%) and board nomination processes (39%).

ii) National competitive neutrality arrangements

National measures to ensure competitive neutrality between SOEs and private enterprises have been reviewed by the OECD at various instances.[78] The gist of these reports is that while relatively few countries have established a *portmanteau* commitment a majority of OECD and partner countries have implemented elements of a neutrality-framework into various aspects of their laws and regulation. Some of the main findings are summarised below.

In all countries, certain public sector entities are providing goods and services in competition with the private sector – or in areas where private sector businesses could potentially compete. Many governments express commitment to address aspects or elements of competitive neutrality in the presence of government-owned businesses. However, this commitment is usually not manifested explicitly in the form of policy frameworks, laws or regulations enshrining the principle of competitive neutrality. In fact, in most cases, such commitments are expressed implicitly through competition policy and a mosaic of other laws, regulations and guidance that apply to the activities of government-owned/controlled businesses and activities of

general government. These commitments can be categorized as follows (Refer back to Figure 4.2):

- *Explicit policy statements on competitive neutrality.* Few **countries** (e.g. **Australia, Denmark, Finland, Netherlands, Spain, Sweden, United Kingdom**) have explicitly addressed and built-in the enforcement of competitive neutrality to their national policies, these are either comprehensive competitive neutrality frameworks or competition law and other targeted policies that are aimed explicitly at achieving competitive neutrality in mixed markets. In these cases, the application of such frameworks goes beyond traditional SOEs to include a broader definition of what constitutes government "business" (Box 5.3).[79]

- *Competition laws and policies*. In **most countries**, aspects of competitive neutrality are dealt with through competition laws and policies. While most of these policies explicitly give public and private businesses equal rights and obligations, the extent to which competition policies and laws apply to different types of government businesses differs.[80]

- *Constitutional commitments.* In some other OECD and partner countries (e.g. **Brazil**, **Chile, China, Hungary, Mexico, Malaysia, Peru** and **Russia**), the overall commitment to level the playing field is enshrined in the Constitution. Among the Latin American countries, this commitment recognises the State's role in the economy ("the State entrepreneur"), while guaranteeing equal treatment before the law. Conversely, in **China** and **Indonesia** the role of State in promoting economic development is constitutionally enshrined.

- *Rules on State aid and transparency.* **EU** and **European Economic Area** (EEA) countries are subject to EU rules which explicitly address the issue of competitive neutrality through the EU rules on State Aid and the Transparency Directive. The rules cover all types of "undertakings" regardless of the legal status or ownership. Interestingly, **Peru** has a similar legal framework in place that covers the "Special Responsibilities" assigned to public entities.

Box 5.3. **Explicit policy statements on competitive neutrality**

Australia: The *Competition Principles Agreement* (1995) agreed among the Commonwealth and all the States and Territories to the overarching competitive neutrality principle that government businesses should not enjoy any net competitive advantages simply as a result of their ownership. The *Australian Competitive Neutrality Policy Statement* (2004) details the application of competitive neutrality principles in the Commonwealth; similar statements are available in all States and Territories. Implementation guidelines exist at the national and sub-national level to assist managers in enforcing the financial and governance framework of competitive neutrality. The Australian Government Competitive Neutrality Complaints Office administers complaints mechanism intended to receive complaints, undertake complaints investigations and advise the Treasurer and responsible Minister(s) on the application of competitive neutrality to government businesses.

Denmark: One of the main stated purposes of the *Danish Competition Act* is to achieve competitive neutrality. It applies to any form of commercial activity as well as aid from public funds granted to commercial activities (public or private). Government controlled businesses and public authorities exercising commercial activity are subject to the prohibitions laid down by the Act.

Finland: Competitive neutrality is high on the agenda of government authorities to ensure by means of competition policy, equal preconditions for private and public service production as applicable in the *Finnish Competition Act*. In addition, the *State Enterprises Act* and the *Local Government Act* apply as respective "companies' acts" stipulating the legal personality, organisation and basic functions of government enterprises. The former was recently amended (January 2011) to incorporate (to the extent possible) companies operating under this act; an amendment to the latter is currently being considered with a view to introduce a corporatisation obligation for municipally-owned economic operators engaged in competition with private operators on a market.

Spain: In addition to the stipulations of the Competition *Act*, the *Royal Decree 1379/2009* introduces specific provisions oriented to reinforce competitive neutrality.

Sweden: Since January 2010, the *Swedish Competition Act* includes a new rule which aims to overcome difficulties faced by anti-trust regulators where previous antitrust rules fell outside the scope of Competition Act and the Treaty on the Functioning of the EU. The rule encompasses all types of government commercial activities and prohibits public undertakings from operating (national and sub-national level) if it distorts or impedes competition. The aim is to avoid market distortions where government-owned businesses are present.

Box 5.3. **Explicit policy statements on competitive neutrality** *(cont.)*

United Kingdom: The *Competition Act* (1998), which is the main legislation that prohibits undertakings from engaging in anti-competitive agreements or by abusing their dominant position, applies to all undertakings, independently of ownership. The UK has undertaken a number of studies examining competitive neutrality namely through the Office of Fair Trading working paper on competitive neutrality in mixed markets (2010)8 and the public sector industry review (*Julius Review)* which recommended competitive neutrality in competitive tendering.

EU and **European Economic Area** (EEA) countries are subject to EU rules which explicitly address the issue of competitive neutrality through EU rules on State Aid and the Transparency Directive. The rules cover all types of "undertakings" regardless of the legal status or ownership. The rules also apply to private companies entrusted with public service obligations (i.e. services of general economic interest); and, companies benefiting from special and exclusive rights. Variations in EU Member States' policies may exist where aspects of such rules are not regulated.

Source: OECD (2012a).

2) The OECD Guidelines on Corporate Governance of State-Owned Enterprises

The OECD Guidelines on Corporate Governance of State-Owned Enterprises (the "SOE Guidelines") were developed in 2005 and substantially revised in 2015 (OECD, 2015a). The SOE Guidelines are addressed to those government officials that are charged with the ownership of enterprises. They provide recommendations regarding the governance of individual SOEs, as well as regarding state ownership practices and the regulatory and legal environment in which SOEs operate. They are generally applicable to SOEs, whether they operate domestically or internationally. According to a widely held view, if a country has implemented the SOE Guidelines fully then most potential concerns about its SOEs' operations in the marketplace (whether domestically or abroad) will have been adequately addressed[81]. However, two issues remain: (1) the SOE Guidelines are set at a high level of aspiration and have not yet fully been implemented by most OECD area governments; (2) non-OECD countries, who are hosts to most of the world's internationally active SOEs, do not adhere to the SOE Guidelines.

This section of the report identifies individual recommendations of the SOE Guidelines which, if adequately implemented, will contribute to overcoming the challenges and concerns identified in earlier sections. It follows an earlier study by the OECD which took a similar approach based in the previous version of the SOE Guidelines (OECD, 2009).

In public debate about the operations of SOEs – foreign and domestic alike – the commonly heard buzzwords include a general acceptance of SOE competitors as long as they operate on "fully commercial terms". It is less clear what this means in practice. As mentioned earlier, the first problem is that governments' motivations for retaining SOEs in state ownership can rarely be described as fully commercial[82]. The Preamble of the SOE Guidelines states the rationale for state ownership thus:

> *1. "The rationale for state ownership of enterprises varies among countries and industries. It can typically be said to comprise a mix of social, economic and strategic interests. Examples include industrial policy, regional development, the supply of public goods, as well as the existence of so-called "natural" monopolies where competition is not deemed feasible".*

Partly for this reason the new version of the SOE Guidelines omits reference to "commercial" and "non-commercial" activities by SOEs. Instead, the focus of the recommendation is SOEs engaged in "economic activities, defined as activities that *involve offering goods or services on a given market and which could, at least in principle, be carried out by a private operator in order to make profits*. Economic activities are juxtaposed to "public policy objectives", defined as objectives *benefitting the general public within the SOE's own jurisdiction… implemented as specific performance requirements imposed on SOEs… other than the maximisation of profits and shareholder value*[83]. Hence in the case of SOEs, a far more realistic objective than a "quest for commerciality" would be the following three steps:

- Establish a degree of clarity around the objectives – economic and otherwise – that a given state-owned enterprise is instructed by its owners to pursue.
- Examine the managerial and related governance structures in place to safeguard SOEs from ad-hoc political interventions and sudden changes of direction that could imperil the credibility of the stated objectives, or undermine the independence and autonomy of the SOEs governing bodies.
- Ensure the existence of a timely and comprehensive disclosure of information concerning the SOE sector as well as individual enterprises,

including with a view to quickly informing the public of changes to objectives and managerial/ownership structures.

- Implement credible measures to ensure a level playing field in the case of competition between the SOEs and other enterprises.

i) Clarity of objectives

The SOE Guidelines offers strong and concise guidance concerning the clarity of corporate objectives. Guidelines I.B and I.D state:

"The government should develop an ownership policy. The policy should inter alia define the overall rationales for state ownership, the state's role in the governance of SOEs, how the state will implement its ownership policy and the responsibilities of those government offices involved in its implementation".

"The state should define the rationales for owning individual SOEs and subject these to recurrent review. Any public policy objectives that individual SOEs, or groups of SOEs, are required to achieve should be clearly mandated by the relevant authorities and disclosed".

If fully implemented these two recommendations would go a long way in alleviating host country concerns about uncertain corporate objectives. Taken together they provide a "blueprint" for, first, making public the objectives that underpin SOE operations in general, second, disclosing any particular responsibilities of individual SOEs. That said, in practice it is obviously unrealistic to expect all public policy objectives to be fully disclosed. Many such objectives will be – even within the state owning the SOEs – implicit rather than explicit. Examples include the expectation in a number of countries that SOEs in the network industries act either as "employer of last instance" providing well-paid jobs in excess of what is operationally efficient, or act as captive clients to incumbent national producers of the relevant equipment. This constitutes a form of "public policy objectives" that has rarely, if ever, been fully disclosed.

However, by establishing mechanisms for regular disclosure of such objectives a government has already taken an important first step. Further steps may include engagements with foreign partners, including governments, concerning the extent and accuracy of disclosure. The existence of such a channel for exchange of information and follow-up is an important confidence building measure – especially where cross-border operations are involved. Box 5.4 provides an example from Norway of the disclosure of economy wide and company specific objectives for SOEs.

Box 5.4. **A Norwegian example of categorising SOEs according to objectives**

Categories of SOEs

The companies owned by the Government of Norway have been divided into four categories depending on the objective of the State's ownership:

1. Companies with commercial objectives:
   a. Companies not subject to any restrictions;
   b. Companies with head office functions in Norway;
2. Companies with commercial objectives and other specifically defined objectives;
3. Companies with sectoral policy objectives.

The main purpose of the State's commercial ownership (the companies in categories 1–3) is to achieve the highest possible return on invested capital over time. Return is the sum total of the change in the market value of a company's equity and direct returns in the form of dividends and any repurchase of shares.

Example of company-specific objectives: Avinor AS

Avinor is responsible for owning, operating and developing a nationwide network of airports for civil aviation and a joint air navigation service for civilian and military aviation. This encompasses 46 airports in Norway, as well as control towers, control centres and other technical infrastructure for safe flight navigation.

The objective of State ownership of Avinor is to facilitate safe, efficient and environmentally friendly air services throughout Norway. Avinor shall, to the greatest possible extent, be self-financed through its own revenues from the primary activities and business activities in connection with the airports. Financially, the entire enterprise is managed as a single unit, which means that the financially profitable airports finance the financially unprofitable airports.

Note: The example of Avinor AS is cited from Christiansen (2011).

Source: Government of Norway (2013), State Ownership Report.

ii) Credibility of governance, credibility through governance – including through their independence and autonomy

In assessing whether an SOE is competent, sufficiently resourced, accountable and has the necessary autonomy to pursue its stated objectives, virtually any element of the SOE Guidelines is relevant. The SOE Guidelines is an integrated, outcomes-based instrument taking a whole-of-enterprise approach to corporate governance. For example, weaknesses in one individual aspect of corporate governance can often be compensated by strengths elsewhere – or corrected through specific intervention through the legal or regulatory frameworks.

As mentioned earlier (and identified as an important "concern" by the surveys cited in the introductory sections) the most problematic cases of SOEs being the subject of repeated "political interference" or day-to-day interventions in their management occur where the SOEs in question are overseen by line ministries and perceived as an extension of the general government service. The way out of this situation recommended by the SOE Guidelines is twofold: establish a central ownership or coordination function at arm's length from other government functions and give SOEs a legal form that establishes them clearly as corporate entities separate from the state. In this respect, Guidelines II.A, II.D and II.E stipulate the following:

"Governments should simplify and standardise the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms."

"The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralised in a single ownership entity, or, if this is not possible, carried out by a co-ordinating body..."

"The co-ordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies…"

The rationale behind these recommendations is that, other things equal, the credibility of any given corporate orientation is bolstered by subjecting the company supposed to embody it to general, enforceable legislation as well as to the oversight of a body with no direct interest in departures from the stated orientation. As for the former point, it is generally held that the credibility of a commitment to market-consistent behaviour by an SOE is a function of the degree of which the SOE is made subject to generally applicable corporate law.

The annotations to the SOE Guidelines particularly recommend the creating of a centralised ownership entity, inter alia "an effective way to clearly separate the exercise of ownership functions from other potentially conflicting activities performed by the state". The text further notes that if the ownership function is not centralised then a minimum requirement is to establish a strong co-ordinating function among the different administrative departments involved. This will generally help ensure that each SOE has a clear mandate and receives a coherent message in terms of strategic guidance or reporting requirements.

At the same time it should be stressed that the usefulness of centralised ownership structures hinge to a large extent on the quality of overall public governance. In a "weak governance environment" where, for example, the

independence and commitment to stated objectives of the ownership entity itself cannot be safeguarded, the centralisation of competence and resources may not accomplish much and could in extreme cases even be counterproductive.

After organising SOEs corporate form and the state ownership function in a manner conducive to corporate autonomy, the main remaining challenge is to reduce the scope for day-to-day interference in SOE management. In this respect Guidelines II.B and II.C state:

"The government should allow SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management. The government as a shareholder should avoid redefining SOE objectives in a non-transparency manner."

"The state should let SOE boards exercise their responsibilities and respect their independence."

When the state is a controlling owner it is obviously in a unique position to nominate and elect SOE boards without the consent of other shareholders. In this process, as noted by the annotations to the SOE Guidelines, the ownership agency should avid electing an excessive number of board members from the state administration. Some OECD countries have decided to avoid nominating or electing anyone from the ownership entity or other state officials on SOE boards. This aims at clearly depriving the government from the possibility to directly intervene in the SOE's business and management. As also noted in the annotations, "directions in terms of broader policy objectives should be channelled through the ownership entity and enunciated as enterprise objectives rather than imposed directly through board participation".

Where boards do include state officials, some additional concerns present themselves regarding the position and lines of accountability of these individuals. A basic requirement is an absence of conflicts of interest: SOE board members should neither take part in regulatory decisions concerning the same SOE nor have any specific obligations or restrictions that would prevent them from acting in the company's interest. As for the more broadly defined board responsibilities (the subject of Chapter VII of the SOE Guidelines), Guidelines VII.A, VI.B and VII.C say the following:

"The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance… The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably."

"SOE boards should effectively carry out their functions of setting strategy and supervising management, based on broad mandates and

objectives set by the government. They should have the power to appoint and remove the CEO..."

"SOE board composition should allow the exercise of objective and independent judgement. All board members, including any public officials, should be nominated based on qualifications and have equivalent legal responsibilities."

Key to ensuring that SOE boards provide effective oversight in the interest of the company is that SOE directors should be subject to the same legally enforceable requirements as the directors of any other company. In most jurisdictions these will include duties of loyalty and care. Directors for the state should be subject to the same requirements as any other board members. In practice this implies that in a jurisdiction where SOE board members have in the past justified their actions in the board room with reference to having "just following orders", serious doubts may be cast on the credibility of any commitment to government non-intervention.

Further safeguard may be needed to shield board members from less direct forms of pressure. Crucially, the nomination and appointment criteria should be transparent and, to the greatest extent possible, merit-based. Box 5.5 provides a national example (from the United Kingdom) of procedures established to ensure the integrity of SOE board nomination procedures. Similarly, the removal of individual board members before the end of their term should generally not be permitted, except in the case of proven transgression of the law or company rules. For example, any request that directors for the state, must submit details of their voting record to their superiors would serve as a clear "warning flag". Company confidentiality furthermore needs to be absolute. Public officials that serve as SOE directors should not be requested to disclose information subject to boardroom confidentiality to their superiors.

Finally, a problem in some countries (as also recognised in the annotations) is that there may be strong links between SOE management and the ownership function, or directly with the government. The SOE Guidelines state that one key function of SOE boards should be the appointment and dismissal of CEOs. Without this authority it is difficult for boards to fully exercise their monitoring function and feel responsible for SOE performance. It needs to be recognised that in some countries 100% owners (the state as well as others) are allowed by law to appoint and dismiss CEOs directly. However, if a state owner were to do so in a discretionary fashion, not based on objective selection criteria and without prior consultations with the board, then serious doubts could be cast on the operational autonomy of the state-owned enterprise in question. An example of a country attempting to establish sound practices in this respect is presented in Box 5.5.

Box 5.5. **Board appointment process in the United Kingdom**

The general Office of Commissioner of Public Appointments (OCPA) recruitment process is as follows (although this may vary slightly depending on the size of the SOE and the specific requirements of the post):

- The central ownership advisory unit, the Shareholder Executive (ShEx) and the SOE Chair agree on the mix of skills and experience required on the Board leading to agreement on a strategic plan of public appointments. A timetable for recruitment is then agreed between the SOE, the lead Director in ShEx and an Independent Assessor (IA).
- A draft specification setting out the role and requirements for the Board appointment is drafted and agreed with HR and the SOE. The role and person specification is then agreed with the body or Minister making the final decision.
- A candidate search is undertaken with the vacant position being publicly announced (i.e. advertised) and often involving the use of recruitment agencies to ensure a more thorough search of potential candidates.
- On the basis of applications received a long list of potential candidates is produced. An initial sift involving ShEx, the IA and the SOE is conducted to produce a short list of candidates to interview.
- An interview panel is established comprising a the lead ShEx policy official, the IA and the Chair of the SOE
- The panel will then reaches agreement on the preferred candidate and submit a panel report with recommendations to Departmental Ministers.
- Once Ministers have agreed the recommendation the appointment can be made.
- An appointment is normally for a fixed period of 3 years at which point the position is subject to re-election.
- The remuneration of the successful candidate, if over £142k, needs to be agreed with the Chief Secretary to the Treasury.

Where the post is not OCPA regulated, the SOE runs the process but follows the OCPA guidelines in most instances. ShEx is closely involved if the post is important (e.g. CEO or Finance Director) in the process. For example, ShEx will be a member of the interview panel. In this way, ShEx is able to make suitable recommendations to give consent for appointments.

Source: Submission by the UK authorities as reproduced in OECD (2013b), "Boards of Directors of State-Owned Enterprises: An Overview of National Practices".

iii) Transparency and disclosure

As mentioned earlier, once an SOE has stated its corporate objectives – economic and otherwise – and, together with its government owners, has established a corporate governance framework that lends credibility to the pursuit of these objectives, the main remaining priority becomes adequate transparency and disclosure to allow outside observers to monitor the continued adherence to these principles and practices. Most actual SOE efforts at transparency and disclosure focus on corporate performance rather than the enterprise's objectives more broadly, but outsiders may nevertheless glean important operational information from high-quality and independently verified disclosure by the state-owned enterprises. Of particular interest in this respect are Guidelines VI.A (sub-items 1, 2, 7 and 8) and VI.B. They recommend:

"SOEs should disclose material financial and non-financial information… including areas of significant concern for the state as an owner and the general public. This includes in particular SOE activities that are carried out in the public interest. Examples of such information include: (1) a clear statement to the public of enterprise objectives and their fulfilment ;(2) enterprise financial and operating results, including where relevant the costs and funding arrangements pertaining to public policy objectives;… (4) any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE…; (5) any material transactions the state and other related entities."

"SOEs' annual financial statements should be subject to an independent external audit based on high-quality standards. Specific state control procedures do not substitute for an independent external audit."

The Guidelines essentially recommend that SOEs should be as transparent as publicly traded corporations. The Guidelines (as further spelt out in the annotations) highlight the importance of non-financial disclosure – particularly where SOEs are charged with carrying out public policy objectives. This is important to the government owners themselves where overseas operations give rise to risks that could have a significant impact on the state budget. It is further important in allowing regulators and policy makers to ensure themselves that foreign SOEs operating in their jurisdiction do not depart from commonly accepted corporate norms or, if they do, that the nature of their operations is fully disclosed prior to their market entry.

Moreover, the SOE Guidelines recommend disclosure of one-off financial assistance from the state to SOEs, but also the inclusion of such information in regular financial reporting. Disclosure should include details on any state grant or subsidy received by an SOE, any guarantee granted by

the state to the SOE for its operations, as well as any commitment that the state undertakes on behalf of an SOE. The annotations further offer that "it is considered good practice that parliaments monitor state guarantees in order to respect budgetary procedures" – which, if fully implemented, may help establish further safeguards against ad-hoc government interventions in the competitive landscape.

When it comes to reassuring foreign regulators and other concerned parties who may be located far from the SOEs in question external auditing of disclosure is also crucial. There is a tendency in some governments to rely mainly on existing state auditing bodies and other intra-government control instances to oversee SOEs, but the SOE Guidelines recommend going further. Their annotations note that "to reinforce trust in the information provided, the state should require that, in addition to special state audits, at least all large SOEs be subject to external audits that are carried out in accordance with international standards". In the context of SOEs operating across borders, where observers in the partner country may already harbour doubts about the independence of different branches of the general government in the SOEs' home country, this recommendation is potentially of great importance. iv) SOEs in the marketplace: maintaining a level playing field

One of the main novelties in the revised SOE Guidelines is a separate section (Chapter III) dealing with the maintenance of a level playing field, which was inspired by earlier work by OECD on competitive neutrality. The "overarching guidelines" at the beginning of the Chapter posits (the detailed individual recommendations are reproduced in Box 5.6):

"Consistent with the rationale for state ownership, the legal and regulatory framework for SOEs should ensure a level playing field and fair competition in the marketplace when SOEs undertake economic activities."

If fully implemented this recommendation goes very far toward allaying the concerns about SOEs' international operations outlined in previous sections. Of note, the text (as well as the individual recommendations in the Chapter) does not apply uncritically to SOE operations. It addresses "economic activities" in respect of their impact on the "marketplace". The implication is that SOE actions that are carried out in pursuit of public policy objectives may not necessarily be competitively neutral. However, of great importance in a cross-border context, the introductory "Applicability and Definitions" section of the SOE Guidelines posits:

"For the purpose of these Guidelines, public policy objectives are those benefitting the general public within the SOE's own jurisdiction."

Box 5.6. **Chapter III of the SOE Guidelines: State-owned enterprises in the marketplace**

Consistent with the rationale for state ownership, the legal and regulatory framework for SOEs should ensure a level playing field and fair competition in the marketplace when SOEs undertake economic activities.

A. There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.

B. Stakeholders and other interested parties, including creditors and competitors, should have access to efficient redress through unbiased legal or arbitration processes when they consider that their rights have been violated.

C. Where SOEs combine economic activities and public policy objectives, high standards of transparency and disclosure regarding their cost and revenue structures must be maintained, allowing for an attribution to main activity areas.

D. Costs related to public policy objectives should be funded by the state and disclosed.

E. As a guiding principle, SOEs undertaking economic activities should not be exempt from the application of general laws, tax codes and regulations. Laws and regulations should not unduly discriminate between SOEs and their market competitors. SOEs' legal form should allow creditors to press their claims and to initiate insolvency procedures.

F. SOEs' economic activities should face market consistent conditions regarding access to debt and equity finance. In particular:

1. SOEs' relations with all financial institutions, as well as non-financial SOEs, should be based on purely commercial grounds.
2. SOEs' economic activities should not benefit from any indirect financial support that confers an advantage over private competitors, such as preferential financing, tax arrears or preferential trade credits from other SOEs. SOEs' economic activities should not receive inputs (such as energy, water or land) at prices or conditions more favourable than those available to private competitors.
3. SOEs' economic activities should be required to earn rates of return that are, taking into account their operational conditions, consistent with those obtained by competing private enterprises.

G. When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be competitive, non-discriminatory and safeguarded by appropriate standards of transparency.

Source: OECD (2015a).

The implication of this is that the owners of SOEs should now allow any public policy objectives that these enterprises are charged with pursuing "spill over" into other jurisdictions. For example, it would be consistent with the SOE Guidelines to impose public service obligations on a national airline with regards to connectivity of outlying parts of the country, but inconsistent with the Guidelines to induce international expansion objectives inconsistent with normal corporate practices. The detailed recommendations in Chapter III further propose mechanisms to ensure that any privileged position an SOE may have in domestic markets due to public policy obligations are separated from its economic activities in the (domestic and) international marketplace.

The point about regulatory independence discussed above is further strengthened through Guideline III.A, which states:

"There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation."

Again, regulatory independence is obviously a good practice for a number of reasons. In the context of credibility of commitments the challenge to overcome is the risk that overly detailed or ad-hoc regulation could be used effectively to usurp some of the powers of the ownership entity. The annotations to the Guidelines note that an important case is when SOEs are used as an instrument for industrial policy. "[This] can easily result in goals confusion and conflicts of interest between branches of the state. A separation of industrial policy and ownership need not prevent the necessary co-ordination between the relevant bodies, and it will enhance the identification of the state as an owner and will favour transparency in defining objectives and monitoring performance." In a cross-border context the separation of ownership and regulation will further help address several of the concerns by foreign regulators and policy makers referred to in earlier sections. In short, it is in many cases a key condition for ensuring that existent legislation and regulation in an SOE's home jurisdiction can be credibly enforced.

5.3. Benefits and challenges of a corporate-governance based approach

As repeatedly mentioned, not every potential problem arising from the cross-border operations of SOEs is most suitably remedied by the owners. As also discussed in the previous sections, from the owners' perspective, basically two categories of corporate governance concerns arise from overseas operations of SOEs, namely (1) agency problems, managerial challenges and compliance issues that either arise from, or are compounded by, the cross-border realities; and (2) challenges that may arise from adverse

reactions to SOEs' operations abroad from policy makers, regulators and the public and press of the concerned countries.

The first of these categories cannot realistically be addressed through any other means than the implementation of adequate ownership, corporate governance and transparency practices. In providing guidance and best practices in this respect the SOE Guidelines have stood the test of time and, the new and revised version of the instrument takes important additional steps. As also demonstrated in earlier sections the revised SOE Guidelines, if fully implemented, goes a long way in addressing potential concerns among foreign regulators about SOEs competing in their markets. The last question to be addressed is whether they are sufficient in addressing all action that can realistically be undertaken by SOE owners, or whether additional good practice may be warranted.

Dealing with foreign perceptions and concerns

Further priority areas that offer themselves based on the previous sections include measures to ensure cross-border regulatory compliance; and strengthening procedures for transparency and disclosure. The issue of information is of overarching importance: significant information asymmetries may arise when SOEs – even SOEs that disclose high-quality information in accordance with the SOE Guidelines – operate across borders. SOEs and their government owners may well consider that they have disclosed plentiful information in accordance with good practices, but when those SOEs expand abroad they will be faced with regulators and policy makers who may not understand the language in which the disclosure is made; who may not fully understand the corporate culture and legislation of the SOEs' home country; who may lack the resources to assess a large number of individual SOEs; and who may in some cases lack an overall understanding of SOEs and their *modus operandi* because such enterprises are largely absent in the domestic context. One way of addressing this issue might be to develop a commonly agreed "reporting template" that would the owners of SOEs to provide sufficient information to satisfy the regulatory needs of their trade and investment partner countries.

Regarding specific issues addressed by the SOE Guidelines, as already discussed in the previous section, the principal considerations for the government owners to allay foreign concerns would be (1) clarifying and discussing SOE objectives; (2) enhancing the credibility of these objectives, through sound regulation and governance practices – including through their independence and autonomy; and (3) enable monitoring through strengthened transparency and disclosure. In the context of the SOE Guidelines, the following provisions may need to be more closely examined:

- *Guideline III.C and III.D on transparency, disclosure and adequate funding of public policy obligations of SOE.* As mentioned above, in a strict interpretation of the recommendations public policy obligations are purely domestic, and the provisions regarding their separation from other SOE activities and a level playing field for those activities that are of an economic nature should in principle prevent a "cross-border spillover" of practices the could compromise the competitive landscape. However, in the context of cross-border trade and investment a contribution to mutual trust could be made if the commercial partners were to agree on more targeted language, aiming at identifying and taking into account the interests of all concerned communities.

- *Guideline III.E on non-exemption of SOEs from laws and regulations.* The existing language is already unambiguous and generally applicable to the cross-border context. However, some enforcement issues suggest themselves, which may be compounded where government owners, contrary to the advice of the SOE Guidelines, continue to exempt SOEs from the application of certain rules in their home jurisdiction. If the SOE Guidelines, or a body of supplementary guidance, were to address this issue a relevant recommendation might address the issue of regulatory and supervisory cooperation between the involved jurisdictions.

- *Chapter VI on transparency and disclosure.* The need to ramp up the effort to inform the public where cross-border operations are involved cuts across the Chapter – though perhaps less so with regards to Guideline VI.B which deals with auditing and accountancy that are subject to regulation in each individual jurisdiction. Related to the overarching case for better disclosure made above, an argument could be made for developing a specific recommendation regarding heightened standards of communication where multiple countries or jurisdictions are affected by the SOEs' operations.

Chapter 6

Policy challenges and options regarding state-owned enterprises

This chapter summarises evidence found in this report to assess the degree to which concerns related to SOEs as global competitors are shared by regulators and businesses. It further draws dividing lines between various policy communities on the types of challenges, and weighs in on the main concerns that need be addressed: namely: maintaining a level the playing field, and reconciling SOE public policy obligations. It considers the importance of these challenges and the policy tools that currently exist to help governments maintain a level playing field between SOEs and the private sector.

This report has identified two main areas of potential concerns that the internationalisation of SOEs may give rise to. As noted, the growing participation of state-owned entities in foreign trade and investment rarely create fundamentally new challenges for regulators and policy makers. More often, concerns that also arise in the context the international transactions of private companies are exacerbated by the unique characteristics of SOEs, including widely perceived implicit guarantees from the state and their proximity to the sovereign powers of individual nations. The two main sources of concern are:

- *A level playing field.* Since governments that own SOEs, benefit from their financial and other performance and, at the same time, establish the legal and regulatory framework in which they operate, there are clear incentives to create a favourable operating environment for these enterprises. This is particularly the case where there is no (domestic) competition to the SOEs from private enterprises. As documented by the OECD in numerous studies this may include (but is not limited to) direct subsidies, preferential access to finance (either deliberately or because lenders perceive a government guarantee for the SOEs), artificially low rate-of-return requirements, a cosseted position in domestic markets, regulatory preference, tax concessions and preferential treatment in public procurement. Privately owned companies may also enjoy some of these benefits – not least those considered by governments as "national champions" – but preferential treatment of SOEs is particularly problematic because it is harder to detect and, given the owner's status as a sovereign state, rules can be harder to enforce.

- *Public policy objectives.* The rationale for state ownership of enterprises is often that these enterprises are expected to act differently from private firms in like circumstances[84]. In many cases these reasons are quite harmless from an international perspective, limited to the provision of certain public services to a domestic constituency. However, in some cases they may (by accident or design) spill over to other jurisdictions – for instance where continued "life support" to an ailing SOE keeps alive what from an overseas perspective may be an unwelcome competitor; or where subsidised over production might lead to excessive capacity. If the public policy objectives directly target foreign jurisdictions (e.g. information gathering, acquisition of sensitive technologies, establishing a strategic position in certain market segments) in the interest of the home countries of SOEs then they may well be perceived as nefarious by the partner countries.

The following section discusses the evidence found in this report to assess the degree to which these concerns are shared by regulators and

businesses, and can be substantiated by observations. It further draws dividing lines between various policy communities, attempting to identify concerns that may need to be addressed in some contexts but not in others.

While the focus of the report is mostly on SOEs that internationalise through trade or investment, a few additional points are worthy of notice and will be touched upon briefly. First, a special situation arises when an economy with large domestically-operating SOEs integrate into the global economy, because it raises the spectre of foreign private firm entering the domestic economy and thereby finding themselves in competition with the SOEs. Secondly, where a number of trade and investment instruments are "ownership neutral" it should be kept in mind that SOEs can be, and apparently sometimes are, used to convey unfair advantages on privately owned companies.

6.1. Weighing in on the main challenges

a) Maintaining a level playing field

There are strong perceptions among policy makers and business people – and some, more limited, pieces of empirical evidence – suggesting that SOEs in the global marketplace do not always operate on a level playing field (or, as also phrased in this report, enjoy "undue advantages"). According to the opinion surveys undertaken as part of the background paper to this report (Sultan Balbuena, 2016) investment regulators were particularly concerned that SOEs entering their jurisdictions enjoyed access to outright subsidies or preferential financing from their government owners, or benefited from a shielded position in their home markets. In each case more than 60% of the respondents cited this as an issue of "strong" or "somewhat" concern. According to the survey of private business executives undertaken by the OECD, well over 60% of the respondents indicated that they are concerned (citing "strong impact" or "some impact") about foreign SOEs receiving subsidies, tax concessions, in-kind subsidies, concessionary financing and/or preferential regulatory treatment. It bears mentioning, however, that many of the respondents perceived that foreign privately owned competitors could be receiving some or all of these benefits from their home country governments, but in general the concerns were significantly stronger where SOEs were involved.

Based on the further analysis of internationalisation of SOEs through trade and investment, most of the evidence focuses on two aspects of SOEs' operating conditions. They are commonly seen as having lower financing costs, whether due to concessionary loans from state-related financial institutions or agencies, the acceptance of unusually low rates-of-return or dividends by their government owners or, as is almost universally the case,

preferential loans by private financial institutions who perceive a low risk when lending to a government-related entity. In the case of international investment (as illustrated in Chapter 2) this may be a source of additional advantage because it enables the funding of individual transactions – for instance through project finance from development banks and similar state-owned financial institutions to favoured SOEs and/or favoured overseas projects.

Among the other apparent advantages for SOEs in international trade and investment the report identified evidence that some SOEs enjoy a preferential position in their domestic market that they can successfully leverage into commercial advantages when they expand into other markets. The preferential position may often include a near-monopoly or incumbency benefits, but can also extend to regulatory forbearance, free access to resources and preferential treatment in public procurement. Sometimes, without even expanding into other markets, preferential treatment in the domestic market may have an impact on international trade and investment since markets extend well beyond geographic borders.

Finally, the issue of foreign sovereign immunity remains prominent on the radar screens of regulators. True, a number of court cases in individual countries in recent years have established jurisprudence limiting this out carve-out to operations by SOEs that are clearly non-commercial, but this is not universally the case and in a number of countries serious concerns remain about the degree to which regulators and law enforcement would be able to take steps against SOEs that are closely aligned with state priorities.

At the same time, a world of caution is due. A number of SOEs, including those active abroad, remain charged with significant public service obligations in their domestic markets which – unless they were granted certain advantages by their government owners – would render them commercial unviable. The challenge for maintaining an internationally level playing field is to design the compensation in such a way that it does not compromise the competitive environment and, if anti-competitive (predatory or other), be caught under anti-trust enforcement. In practice this can be done by carefully calibrating a compensatory payment (e.g. via a subsidy or an agreement to forego dividends from the SOEs) to the estimated cost of public service obligation. Conversely, if the compensation granted to the SOE is of a form that is proportional with the its business volume rather than with the cost of the public service obligation (e.g. the granting of tax concessions, soft loans and/or artificially low rate-of-return requirements) then the SOE in question will effectively have an incentive to expand its business volume, including in overseas locations.

b) SOEs pursuing public policy objectives abroad

Concerns about SOEs expanding abroad in pursuit of non-commercial objectives are mostly related to foreign direct investment rather than arms-length trade – with the possible exception of the acquisition of "strategic" assets or raw materials. According to the opinion surveys undertaken as part of the background paper to this report (op. cit.) investment regulators were particularly concerned that SOEs entering their jurisdictions obtain control over critical infrastructure (77% of the respondents had "strong concerns" or "some concerns" about this) or gain access to strategic technology or natural resources (a total 65%). Perhaps more surprisingly only a minority of the respondents (39%) had concerns about outright military or industrial espionage, and while a significant share of the respondents (31%) said that SOE entrants pose more of a national security threat than foreign private firm, around half of the respondents replied that they see no major difference.

Insofar as there are special concerns about SOEs from this perspective it would seem to relate to the degree to which these enterprises are perceived as acting on behalf of foreign governments. No less than 80% of the respondents had concerns about the risk of political interference in the operational decisions of foreign SOEs operating on their territory. In addition a degree of concern was voiced (around half of the respondents in each case) about the quality of information that can be obtained from foreign SOEs and the risk of getting entangled in foreign corrupt practices.

The type of concerns cited above typically involves considerations about national security of country receiving foreign investment. Consequently, much of the evidence cited in Chapter 2 derives from security-related reviews under national law or international treaty obligations. The report concludes that concerns about foreigners controlling critical infrastructure are a significant factor, citing recent cases from the OECD area within the transport and communications sectors. At the same time, it would seem that the investors' "foreignness" is as important a factor to regulators as the fact that they may be state-owned. An additional complication has sometimes arisen where it was difficult to establish the ultimate beneficiary ownership and lines of corporate control of would-be investors.

Two other important concerns for investment regulators identified by the report is the possibility that foreign owned enterprises might be used as a source of illicit information gathering or to control the access to strategic resources and/or important market segments. The report cites important cases of IM&As being blocked by regulators in recent years, allegedly for fears of espionage. Likewise, there is evidence that SOEs' IM&As are more likely to target sectors representing "strategic assets" (e.g. mining; oil and

gas) than private firms[85]. On the other hand, if SOEs were systematically and proactively used prioritised policy purposes one would expect to see a significant take-over premium on the price that these SOEs pay for their overseas acquisitions. The report (and earlier work by OECD) finds little evidence that this is the case. A tentative conclusion might be that SOEs are indeed interested in acquiring foreign "strategic" assets and technologies, but this is done mostly done opportunistically rather than as part of a government-led "push" in that direction.

c) Other challenges and concerns

Another important concern is the advantages that may be granted by SOEs to other firms through lower prices or better accessibility of inputs. According to the survey of business executives cited in Part A of the report this is perceived by no less than 89% of the respondents as being a competitive problem[86]. Considering the concentration of SOEs in the basic utilities and financial sectors there is obviously considerable scope for aiding the competitiveness of private firm through this channel – including through financial assistance to project financing if some of these firms engage in overseas activities.

Finally, SOEs may effectively impede cross-border competition without even operating outside their own jurisdiction. For example in the context of fostering cross-border competition in the network industries the presence of large incumbents (which are usually, but not necessarily, state-owned) has in some cases effectively impeded the entry of foreign competitors. Where the incumbents retain an element of legal monopoly in the public interest this may be defended as an exercise of the national authorities' right to regulate, but if competition is in principle allowed and the incumbent is kept in place mostly though preferential treatment then this marks a serious departure from the principle of competitive neutrality. As also noted earlier, preferential treatment in the domestic market may have an impact on international trade and investment since markets extend well beyond geographic borders.

6.2. Policy options

It follows from this report that almost all of the concerns, whether merely perceived or borne out by empirical facts, identified in the previous section could be addressed of the owners of SOEs fully implemented the OECD *Guidelines on Corporate Governance of State-Owned Enterprises*. The revised SOE Guidelines contain detailed recommendations for maintaining a level playing field (where SOEs engage in economic activities) that apply equally to domestic and foreign transactions. And

while they condone the pursuit of public policy objectives through SOEs (provided that they are subject to transparency and adequate funding arrangements and are not market distorting) they expressly state that such objectives should be limited to the domestic constituency of the SOEs.

However, most of the internationally active SOEs are owned by governments that are not members of OECD. Also, even among the Organisation's member countries the implementation of the Guidelines is uneven and not subject to regular monitoring. One way forward would hence be to (1) encourage a wide range of emerging countries to adhere to the SOE Guidelines; (2) establish a mechanism for reporting and monitoring the implementation of the Guidelines that would apply equally to OECD countries and non-member adherents to the Guidelines.

With regards to the two main potential sources of disruption from SOE internationalisation, investment regulators are relatively well equipped to deal with "public policy objectives". International investment instruments (including those hosted by the OECD) allow governments to take steps to prevent investment infringing on their national security. And, in practice, governments have given themselves a relatively wide berth in deciding what elements of the national interest can be considered as covered by this carve-out. In addition, safeguarding these types of interest hardly rest on investment regulation alone: governments have relatively broad freedoms to legislate against unwanted actions by enterprises operating within their jurisdiction, which in turn can be addressed by other public bodies such as law enforcement and competition agencies.

Conversely, investment regulators have traditionally been weakly equipped to address any "undue advantages" of foreign entrants. Traditionally, international investment agreements have identified foreign governments as a class of investors like any other, and granted them equal market access and/or national treatment protections. Only relatively lately have governments' begun to address, in bilateral and regional investment agreements, demands regarding the operating conditions, information disclosure and governance of foreign SOEs entering their jurisdictions. At the international and multilateral level there has been no collective response to date. Without going as far as a multi-lateral agreement on cross-border SOE investment (such as was done to address concerns over investments by sovereign wealth funds in the Santiago Principles in 2009), it might be worth considering a set of internationally agreed guidelines on, at minimum, what concerns need to be better assessed, and what domestic policy tools countries can implement in response to preserve a level playing field for investment while avoiding any unnecessary protectionism. At the same time, any policy consensus or mutual agreement at domestic or international level must also take into account – and enhance transparency on – the extent to

which privately owned firms also receive official support for their outward investment.

Trade regulators are in principle quite well equipped to deal with the "undue advantages" of SOEs and any other participants in the global trading system (at least where trade in goods is concerned). WTO rules, which are by design ownership neutral, notably the Subsidies and Countervailing Measures Agreement, discipline subsidisation – including of SOEs – and the WTO dispute settlement rulings on the question of "public body" provide guidance regarding the importance of ownership when determining cases of possible subsidisation by state-owned or otherwise state-linked enterprises.

However, Chapter 3 identified some apparent shortcomings. The continued high level of concerns about trade-distorting subsidies could be taken to indicate that WTO subsidy rules could need tightening. The analysis further suggests that similar rules regarding regulatory and related advantages should perhaps be developed. Any strengthened disciplines on subsidies and other advantages, even if not targeting SOEs directly, could have important ramification for the international trade by SOEs.

As seen in Chapter 4, competition law offers a wide range of tools/disciplines that can be an effective way to prevent/remedy anti-competitive conduct by state-owned enterprises. These tools can prevent the abuse of dominance (such as through predatory behaviour by SOE), they can block or remedy anti-competitive mergers, and can serve to break up cartels. However, not all aspects needed to ensure a level playing field on a global scale can be caught by competition enforcement. For this, comity and other reciprocal commitments may be necessary – such as increased harmonization of competition policies across jurisdictions (including advocacy), broader commitments to competitive neutrality, more harmonized accountability and transparency requirements by SOEs, and more consistent application of rules concerning subsidies or state aid – to ensure that policies in one jurisdiction do not advertently or inadvertently impact the competitive environment in others.

Moreover, as the volume of cross-border transactions continue to rise, the complexity faced by competition agencies (and other enforcement agencies) in obtaining information and evidence located outside their jurisdiction and in enforcing their decisions against foreign companies is increasing. As such regulatory and enforcement co-operation, along the lines of the OECD Recommendation concerning International Co-operation on Competition Investigations is key to ensure that investigations, including those involving state-owned enterprises, can be effectively addressed by the competent authorities.

In conclusion, as international dialogue on conduct of internationally active state enterprises and policy responses expands, it is important that governments continue to honour their commitments under international agreements and that they act in the spirit of non-discrimination. This implies that governments should neither use state enterprises to influence competition in international markets nor should they unduly discriminate against foreign state enterprises that trade and invest according to market principles.

Notes

1. For a summary of the discussion see OECD (2010), *State-Owned Enterprises and the Principle of Competitive Neutrality*.

2. However, when companies owned by sub-national levels of government are included then, by some estimates, the share almost doubles.

3. This threshold is applied to foreign direct investment statistics as indicative of a "lasting interest" by the investor, and it is cited by the revised OECD Guidelines on Corporate Governance of State-Owned enterprise as a state ownership above which the Guidelines may be considered as applicable to a given enterprise.

4. The share of the economy is approximated by OECD (2014d) by SOEs' share of total dependent employment.

5. As a general rule the owner is an agency of the enterprise's national government, although a couple of cases of cross-border ownership by foreign government is included in the table.

6. Like in the case of Table 1.1 only countries whose SOE sectors are valued at above US$ 100 bn. are included in the two figures.

7. For more information on national practices with regard to exemptions refer to the OECD Database on National Practices and Regulations with respect state enterprises which takes stock of the different domestic policies and international obligations of different countries. It is an online transparency tool which informs governments and the public about existing practices and regulations. The database has information on over 45 economies. The database can be accessed at: *http://oe.cd/state-enterprises*.

8. To the extent that they can be considered distortive or only applicable to certain specific enterprises or groups of enterprises. See also OECD *Policy Guidance for Investment in Clean Energy Infrastructure* *www.oecd.org/daf/inv/investment-policy/CleanEnergyInfrastructure.pdf*

9. These were defined as granting cheaper loans (upstream advantages) or providing access to goods and services at favourable prices (downstream advantages).

10. This may explain why a majority of respondents indicate that foreign SOEs are not subject to more intensive monitoring by investment regulators in their jurisdictions.

11. This section as prepared by Anthony Decarvalho and Filipe Silva of the Directorate for Science, Technology and Innovation, OECD Secretariat.

12. OECD Steel Market Developments provide up-to-date information on global and regional steel markets. Further information is available at: *www.oecd.org/sti/ind/steel-market-developments.htm*.

13. The latest update of the database was made in March 2015. Further information on the methodology is available at OECD (2015b) and the OECD Steelmaking Capacity Portal at *www.oecd.org/sti/ind/steelcapacity.htm*. The data portal is updated on a yearly basis in January/February.

14. SOEs were defined in this study as firms that are owned by the government either through direct or combined indirect ownership links. Ownership is defined as holding more than a 50% share in a given company. The definition is based on the ultimate parent company, *i.e.* ownership is traced back, through the different ownership links, to the company\agency that ultimately owns the target steel company. Ownership by a government related agency is identified by searching a number of keywords in the ultimate parent company name. Keywords include "Gov" "Province" "City" "State". Nevertheless, a number of government related agencies and\or companies might still not be captured, thus ownership by a government related agency might be underrepresented.

15. This chapter was prepared by Michael Gestrin and Carole Biau, Directorate for Financial and Enterprise Affairs, OECD Secretariat.

16. The main exception has been cases where the owners of ailing SOEs have invited foreign "strategic partners" into the shareholding to provide not only capital but also foreign know-how and expertise.

17. OECD (2011b).

18. In practice, however, SOEs would usually claim that such benefits, where they exist, are barely sufficient to cover the costs public service and other political "expectations" are therefore hardly confer a commercial advantage.

19. This is in addition to the two significant longstanding exceptions to the absolute immunity of foreign sovereigns, which are: (i) when the state itself initiates litigation; or (ii) when it consents to jurisdiction.

20. Based on investments by around 300 Chinese MNCs (both public and private-owned) in 56 countries, the authors find that the quality of host country rule of law (as well as other variables which can affect the level of institutional pressure on MNEs operating abroad) has a strongly positive relationship with the level of control that private firms acquire in foreign subsidiaries, but a strongly negative (highly moderating) effect on level of control acquired by SOEs.

21. Gavekal Dragonomics, as cited by The Economist, 12 September 2015.

22 . *Freedom of Investment Process: Investment Policies Related to National Security: a Survey* (*DAF/INV/WD(2015)11*)

23. All three countries also have specific definitions of what constitutes a GCI. In Australia, the definition of foreign GCIs includes entities that are directly or indirectly government owned or controlled, and individual and aggregate thresholds apply for mixed ownership. In the Federation of Russia, GCIs include foreign states and entities under their control and international organisations, with some exceptions of international organisations in which the Russian federation is a member; in the United States, GCI investment refers to transactions that could result in the control of a U.S. business by a foreign government or a person controlled by or acting on behalf of a foreign government, including foreign government agencies, state-owned enterprises, government pension funds, and sovereign wealth funds.

24. Office of the Minister of Finance, "Review of the Overseas Investment Act: Report Back on Final Drafting of Regulatory Changes and Ministerial Directive Letter" (2010), *www.treasury.govt.nz/publications/informationreleases/overseasinvestment/pdfs/oi-cp-roiarrb.pdf*, quoted in *Freedom of Investment Process: Investment Policies Related to National Security: a Survey* (*http://www2.oecd.org/oecdinfo/info.aspx?app=OLIScoteEN&Ref=DAF/INV/WD(2015)11*.

25. Based on total assets or transaction values. The threshold amounts are set annually on 1 January and are found at *www.firb.gov.au/content/monetary_thresholds/monetary_thresholds.asp*. There are some exceptions: for example, for New Zealand investors and U.S. investors, the threshold applies only for investments in certain sensitive sectors. See also page 70 of "State-Owned Enterprises: Trade Effects and Policy Implications" by Kowalski, et al. (2013).

26. See also "Australia's Foreign Investment Policy issued in 2013" (*https://www.firb.gov.au/content/_downloads/AFIP_2013.pdf*).

27. See *www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk81147.html*. The statement also includes an announcement that investments by foreign SOEs to acquire control of a Canadian oil sands business will be found to be of net benefit on an exceptional basis. See also page 16 of "Inventory of investment measures taken between 15 November 2008 and 15 February 2013" by the OECD (*www.oecd.org/daf/inv/investment-policy/FOIinventorymeasures_march_2013.pdf*).

. At the same timing, Canadian government approved two acquisitions of Canadian energy companies by foreign SOEs: an acquisition of Nexen by a Chinese SOE, CNOOC and an acquisition of Progress Energy by a Malaysian SOE, Petronas.

28. Article 1 (7) of the Energy Charter Treaty.

29. Article 1 (Definitions) (2)(b) provides that the term "investor" shall mean for the United Arab Emirates:
1. the Federal Government of the U.A.E.
2. the Local Governments and their local and financial institutions.
3. the natural and legal persons who have the nationality of the U.A.E.
4. companies incorporated in the U.A.E.

30. These are Canada-Benin (BIT), Canada-Tanzania (BIT), Colombia-Korea (FTA), Japan-Mozambique (BIT), and Japan-Saudi Arabia (BIT).

31. OECD (2009), "Foreign Government-Controlled Investors and Recipient Country Investment Policies: A Scoping Paper".

32 . Article 13 (a)(iii) of the Multilateral Investment Guarantee Agency Convention (MIGA Convention).

33. This chapter was prepared by Przemyslaw Kowalski and Kateryna Perepechay of the Directorate for Trade and Agriculture, OECD Secretariat.

34. A notable exception is the EU where the community-level state aid and competition policies are integrated.

35. See:
http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153030.pdf

36. See OECD (2013b) for a more extended discussion of competitive neutrality provisions in Australia and the EU from the perspective of cross-border competition.

37. The 2012 OECD report on competitive neutrality provided examples of relevant practices but it did not attempt to identify best practices or develop guidelines (OECD, 2012a).

38. See e.g. OECD (2011) and OECD (2013b).

39. Although they are beyond the direct scope of this report, bilateral investment treaties are also an important part of the picture. Some aspects of treatment of state enterprises in these agreements have been covered by OECD (2013b) and Shima (2015).

40. In US-Korea, for example, this includes control through ownership interests. Ownership, or control through ownership interests, may be direct or indirect. See the text of the Agreement at: *https://ustr.gov/trade-agreements/free-trade-agreements/korus-fta/final-text*

41. See e.g. Kawase (2014).

42. See: *http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153030.pdf*

43. The OECD Database on National Practices and Regulations with respect to state enterprises takes stock of the different domestic policies and international obligations of different countries, also takes stock of and external obligations with respect to the state sector (WTO, PTAs and BITs). See also FN 7. The database can be accessed at: *http://oe.cd/state-enterprises*.

44. This has also been flagged by Hufbauer et al. (2015) who suggested the definition of covered state enterprises could become a threshold issue for potential future negotiations.

45. E.g. Potter (2001).

46. See e.g. Gestrin and Shima (2013) or Kowalski et al. (2013).

47. This chapter was prepared by Sara Sultan Balbuena, with input from Antonio Capobianco and Mona Chammas, Directorate for Financial and Enterprise Affairs, OECD Secretariat.

48. For further analysis of this point see *http://www2.oecd.org/oecdinfo/info.aspx?app=OLIScoteEN&Ref=C/MIN(2014)17http://www2.oecd.org/oecdinfo/info.aspx?app=OLIScoteEN&Ref=C/MIN(2014)17*

49. Another strategy discussed in Capobianco and Christiansen, 2011 and could be an area of concern is “strategic choice of a technology”. The author’s note that: “If an SOE is in a position to strategically choose the technology, e.g. it has a choice among various production technologies that it can implement, it may use this opportunity to operate with an inefficient technology that secures a relatively low marginal cost at the expense of a particularly high overhead (fixed) costs. The reason for pursuing such a strategy would be to secure an abnormally low level of marginal costs in order to relax a binding prohibition on pricing below costs.”

50. Such as through the OECD Competition Committee and the International Competition Network (ICN) which offers a platform for authorities to exchange experiences on enforcement issues.

51. See also the International Competition Network's 2014 Survey (ICN, 2014) , which comes to the same assessment as the results emanating from the OECD Database: *www.icnmarrakech2014.ma/images/SOE_under_competition_law_Morocco.pdf*. Also see Fox and Healy (2013) for similar results emanating from an UNCTAD survey.

52. Furthermore there may be exceptions beyond the category of SOE. For example business activities of unincorporated public businesses, ring-fenced public businesses, state or other public institutions, and recently privatized companies which maintain incumbency advantages.

53. In most jurisdictions, abuses and cartels are prohibited and punished with heavy sanctions, such as pecuniary fines professional disqualification, and/or jail sentences; whereas mergers and acquisitions are subject to preventive control and can be barred if they raised irremediable competition concerns. The first two issues are examined below, as part of anti-trust enforcement under section 2. The third issue on M&A control is examined in detail under section 3.

54. Relevant markets include all products or services deemed substitutable from a demand and supply perspective. The geographic width of the market essentially depends on how far customers would reasonably go for alternative suppliers. See European Commission, 2015b.

55. For example, competition authorities may encounter difficulties in enforcing a decision against a foreign SOE if the same conduct is not prohibited in the SOE's home country.

56. See also OECD, 2015d.

57. In other words a competition authority might have to determine whether the entities are different state-controlled entities acting independently from the state and as distinct entities from one another, and then would have to determine whether co-ordination among would qualify as anticompetitive.

58. Similar considerations apply to abuse of dominance cases.

59. See EC Merger Regulation, para 22, "The arrangements to be introduced for the control of concentrations should, without prejudice to Article 86(2) of the Treaty, respect the principle of non-discrimination between the public and the private sectors. In the public sector, calculation of the turnover of an undertaking concerned in a concentration needs, therefore,

to take account of undertakings making up an economic unit with an independent power of decision, irrespective of the way in which their capital is held or of the rules of administrative supervision applicable to them." See also a 2011 statement by the EC Deputy Director of Merger Control, "Where a state-owned company is run independently from other companies owned by the same state, it will be considered as a separate party to the transaction. Where decisions are taken by the state across companies, the other companies have to be also included for the assessment of the consequences of the transaction." http://ec.europa.eu/competition/speeches/text/sp2011_07_en.pdf

60. See *Competitive Neutrality: Maintaining a level playing field between public and private business* (OECD, 2012a) for an in-depth discussion; also refer to OECD (2015d) for a toolbox of competitive neutrality policies and tools for the main categories of state-related competition distortions

61. An example of effective subsidy control is found in the EU state aid control regime; whereas regulatory impact assessments can be found in various jurisdictions around the world: they consist in assessing the impact of new or existing regulations (e.g. sector regulation) on a variety of parameters, which should but do not always include an assessment of their impact on competition.

62. Also refer to OECD, 2010a for further discussion of the propensity to enforce competition law against foreign-government backed company conduct, versus private entities.

63. For example, if costs between commercial and non-commercial activities are not clearly separated and accounted for, "below-cost" benchmarks used by competition authorities may not be practicable.

64. This chapter was prepared by Hans Christiansen, Directorate for Financial and Enterprise Affairs, OECD Secretariat.

65. Although this phenomenon is not limited to SOEs, it may be an area of concern depending on the SOE's ability to overpay for foreign assets or buy unprofitable target firms. The latter is more likely to happen in SOEs that are fully- owned by the government and not publicly traded, since managers may not face any punishment for making such poor investments

66. An example of this was proposed by an academic study of the behaviour of private and publicly owned German banks leading up to the crisis (Hau and Thum, 2009). See also, OECD (2013c).

67. OECD (2014g).

68. The term "corporate responsibility" is here used synonymously with what might in other contexts be referred to as "responsible business conduct" or "corporate social responsibility".

69. A brief description was provided by The Economist (2013).

70. Some cases are cited in OECD (2012a).

71. For example, several of the competition agencies contributing to OECD (2010a).

72. OECD (2012a).

73. In an additional five countries, reference was made in publicly available resources online to specific SOE codes of corporate governance, but the codes themselves did not appear to be posted online or were inaccessible.

74. See online here: *www.caf.com/media/1390994/lineamientos-gobierno-corporativo-empresas-estado.pdf*

75. Most codes are developed as *non-binding government guidance* documents (19 countries). In 4 countries, the codes were adopted via government *decrees or resolution*; in 3 as *non-government guidance* (see the preceding bullet), and in 4 countries the code was adopted as a *law* or as an annex to a law

76. The *level of required compliance* varies: In 12 countries, compliance with the code is required; in 8 countries, compliance is on a comply-or-explain basis; and in 7 countries, there is no obligation

77. In some jurisdictions separate codes for SOEs are not considered necessary as the existing corporate governance codes applicable to private listed companies are applied equally to SOEs.

78. The underlying analytical material includes an initial stocktaking of practices in OECD member countries (OECD, 2012a) and a subsequent broadening of the analysis to cover a number of partner countries (OECD, 2013c).

79. Ibid. The Competition Committee of the OECD is currently undertaking an inventory of competitive neutrality commitments across jurisdictions.

80. General government activities may fall outside the scope for competition law, or exemptions from competition law may exist in statutory laws for state-owned enterprises (SOEs) in specific sectors, especially in sectors with strategic national security or economic interest.

81. This point was raised by several of the competition regulators contributing to OECD (2010a).

82. In this, SOEs may in practice often not differ much from privately owned companies. One of the rationales for corporate governance codes for private firms is that they are subject to "agency problems" which may induce them to depart from profit and value maximisation under the influence of corporate insiders or majority shareholders not acting in the interest of the company and all its investors.

83. Of note, "economic activities" and "public policy objectives" are not mutually exclusive, and in practice may be often pursued in tandem. One example would be the provision of passenger railway services which is, on the one hand, and economic activity, but on the other hand in many jurisdictions is maintained in the public interest and subject to government subsidisation.

84. Other reasons that are frequently cited include the existence of natural monopolies in some sectors and a political will to maintain national ownership of certain companies.

85. However, it should also be kept in mind that SOEs, especially in emerging economies, are relatively concentrated in these sectors of the economy.

86. Conversely some governments may consider this as an extension of the SOEs' public policy objectives. During an OECD review of Latvia's SOE sector a principal reason for continued state ownership of the country's largest forestry company was that this is needed to ensure a continued provision of inputs to the country's furniture and woodwork industry in times of crisis (OECD, 2015c).

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