Mining for China's Outbound Direct Investment

With skyrocketing economic growth and an economy on track to be the world's largest by 2025, China is seeking overseas investment opportunities. Sharon Wong and Malcolm Brennan of Mallesons Stephen Jaques and Sandra Knowler of Lang Michener explain why much of that outbound investment is likely to be in the energy and resources sector.

With double digit GDP growth since 2003,[1] China is the world's fastest-growing major economy, the world's fourth-largest economy and set to become the world's largest by 2025.[2] This meteoric rise through global ranks has helped produce the world's largest foreign exchange reserve at US$1.81 trillion[3] and positions China as an economic powerhouse.

With pockets full, China is actively supporting its domestic entities to explore overseas opportunities, particularly in the energy and resources sector. Given China's ever-growing appetite to fuel industrialisation and continued growth, this is not suprising. At current rates of depletion, only 21 of the 45 minerals with proven reserves in China will meet domestic demand by 2010, reducing to six by 2020.[4] Mining investment outflows already totalled US$8.54 billion[5] in 2006, representing 40.4% of the nation's entire outbound direct investment (ODI). Even with most of these outflows being acquisitions of stakes in foreign companies by state-owned enterprises (SOEs), more still needs to be done to ensure a sufficient supply of raw materials to build China's infrastructure.

Naturally resource-rich Australia and Canada have become prime targets for China's wandering eye for energy and reserves. In 2006, Canada was the top destination for global mineral exploration, capturing 19% of world spending, followed by Australia at 11%.[6] Canada is also the third-largest producer of natural gas in the world and is second only to Saudi Arabia in proven reserves for natural gas from oil sands.[7] Australia is China's largest source for iron ore and alumina, the second-largest for coal and the fourth-largest for copper ore.[8]

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Both Commonwealth countries are identified in China's Catalogue of Foreign Countries and Industries for Guiding Outbound Investment (Catalogue) as desired mining investment destinations, and tout diverse economies and institutional and political stability as their primary advantages. However, the foreign direct investment (FDI) regimes in Australia and Canada are arguably among the most restrictive in the world. Open sensitivity together with recently-issued guidelines directed at investments by SOEs in both jurisdictions raise queries about whether foreign investment in Australia and Canada will only get tougher for SOE investments including, but not limited to, Chinese ODI.

Below we examine the FDI regimes in Australia and Canada and comment on the current FDI climate for Chinese companies and SOEs in both jurisdictions.

INVESTING IN AUSTRALIA

Foreign investment into Australia is regulated principally under Commonwealth legislation including the *Foreign Acquisitions and Takeovers Act 1975* (FATA) and the Australian Government's Foreign Investment Policy (Policy). The FATA governs the review regime for FDI in Australia and must be read in conjunction with the Policy.[9] The Policy not only assists with determining whether proposals meet the FATA requirements and the Government's approach to certain industry sectors, but purports in its own right to make certain proposals notifiable even if the FATA does not apply.

The FATA is administered by the Foreign Investment Review Board (FIRB), whose functions are only advisory in nature. Ultimate decision-making lies with the Federal Treasurer, who has power to make adverse orders regarding investments that exceed prescribed monetary thresholds considered by the Treasurer to be contrary to Australia's national interest. There is no definition of what national interest means, and it is assessed on a case-by-case basis. The Policy provides some guidance indicating that the Government must have regard to "widely held community concerns of Australians" but notes that foreign offshore proposals do not normally raise national interest concerns. With the exception of prescribed investors (to date, only United States investors), the FATA and Policy are applied to relevant transactions regardless of investor nationality.

Under the FATA, notification to the Treasurer through the FIRB is required where a foreign person proposes to acquire:

- a substantial interest (15% or more), or an increase in a substantial interest, in an Australian corporation where the total assets amount to A$100 million or more (or if the consideration for the acquisition values the target at A$100 million or more); or
- an interest, or increase in an interest, in Australian urban land. This includes an interest in an "Australian urban land

corporation". Save for some exemptions provided under the Regulations to the FATA (for example, developed commercial property valued at less than A$50 million), there is no dollar threshold for the acquisition of an interest in Australian urban land.

Under the FATA, the Treasurer has powers to make orders for various proposals. In addition to the circumstances giving rise to compulsory notification, the Treasurer's powers may also be active where a foreign person proposes to acquire:

- the assets of an Australian business (including rural land) valued at A$100 million or more; or
- a substantial interest (15% or more), or an increase in a substantial interest, in an offshore corporation where the Australian assets of the target corporation amount to less than 50% of the total assets and the Australian assets are valued at A$200 million or more, (or where the Australian assets are 50% or more of the total assets and the total assets of the target are A$100 million or more).

The Policy provides for notification of the following proposals in addition to the FATA:

- the establishment of a new business where total investment is likely to amount to A$10 million or more;
- direct investment by foreign governments and their agencies irrespective of size; and
- portfolio investments in the media of 5% or more and all non-portfolio investments irrespective of size.

US investors enjoy higher thresholds in non-sensitive sectors[10]. For the calendar year 2008, that higher threshold is set at A$913 million but falls to A$105 million for US SOEs.

While there is a compulsory notice regime in the case of acquisitions in Australian corporations or of Australian urban land, the Treasurer's powers to interfere with proposals may be active regardless of whether a notice is lodged. Applications to the Treasurer are in essence to seek confirmation that he will not exercise his powers. The Treasurer's decision is a "statement of no objection in terms of the Government's foreign investment policy" (FIRB Approval) and, if provided, deactivates the Treasurer's powers for the subject transaction.

In February 2008, the Treasurer released guidelines for foreign government investment proposals (Guidelines).[11] The Guidelines require SOEs (including government agencies and sovereign wealth funds) to address whether:

- an investor's operations are independent from the relevant foreign government;
- an investor is subject to and adheres to the law and observes common standards of business behaviour;
- an investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned;
- an investment may impact on Australian government revenue or other policies;
- an investment may impact on Australia's national security; and
- an investment may impact on the operations and directions of an Australian business as well as its contribution to the Australian economy and broader community.

It is important to note that the Guidelines are not new. They have been the basis of the assessment of SOE investment into Australia for a very long time. The Policy has required SOEs to notify proposals irrespective of size for many years and has been the approach of successive governments regardless of their political stance. The announcement of the Guidelines was largely to clarify that the Policy has application outside of the FATA and that the Government is making sure that SOE investments in Australia are properly notified. What is new in the Guidelines is the transparency of the process.

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What has changed, however, is the Australian government. The current government was elected in November 2007 and has clearly struggled with how to deal with SOE investment, in particular Chinese investment. While proposals are being approved (and many without conditions being imposed), since the election of the government, project approvals have been substantially delayed as they go through the FIRB process.

Under the FATA, the Treasurer has 30 days to review investments, a 10-day notice period and a mechanism for a 90-day interim order extension (that is made public) if considered necessary. There is however no time imposed for responses to applications under the Policy.

It is common for investors finding their applications delayed for whatever reason to withdraw and relodge applications within a fresh 30-day period rather than face a public interim order. This is a long-accepted practice adopted by the FIRB. Earlier this year, when substantial delays were being encountered by SOEs, there was encouragement to adopt the withdrawal practice and avoid interim orders or perhaps even prohibition orders. Continuing delays with processing SOE investments generally (and not just Chinese investment) indicate that the government is still grappling with how to treat SOE investments.

The government's vacillation is jeopardising the integrity of the system and, in particular, causing Chinese companies and SOEs in general much consternation. The recent decision in the Chinalco proposal to acquire an interest in Rio Tinto has, however, given some clarity to the government's position. That is, while notifiable under Policy, there ought not be a national interest concern if the SOE:

- acquires a less than 15% interest; and
- is not appointing a director or having other control elements attached to the interest.

There is however no clear guidance as to the government's approach to higher levels of interest or control. It is understood that the government has particular concern with acquisitions where the SOE is both investor and consumer and the acquisition is designed to influence the price of the Australian commodity for the investing SOE. The Government is also concerned with SOEs that are not established along normal commercial lines.

The Australian foreign investment review process is not a one-off process of application submission and reply. It routinely and inevitably involves prospective investors working with the Australian government to answer queries and revising documentation where necessary, to arrive at a mutually acceptable position designed to preserve Australia's national interest. While this is a process that some argue is difficult, non-transparent and time consuming, there is a very small prohibition rate[12] and most matters do progress to the issue of a FIRB Approval. Matters inconsistent with the national interest may be withdrawn rather than proceed to a formal prohibition.

INVESTING IN CANADA

Canada's FDI is governed by the *Investment Canada Act* (ICA) and, apart from investments in cultural industries,[13] is administered by Industry Canada. Under the ICA, the Minister of Industry must approve any FDI in Canada exceeding prescribed monetary thresholds that depend on whether the prospective investor is a member country of the World Trade Organisation (WTO). Non-WTO investors face a threshold of C$5 million for direct acquisitions and C$50 million for indirect acquisitions, although the latter figure falls to C$5 million if the asset value of the Canadian target is greater than half of the asset value of the global transaction. For WTO investors, the threshold is C$295 million in 2008 (adjusted annually according to a GDP-based formula) and indirect acquisitions are not subject to a threshold but require notification. For investments concerning uranium production, financial services, transportation and cultural industries, the lower non-WTO thresholds apply to trigger review.

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Under the ICA, a prospective investor (as opposed to the government) must demonstrate that the proposed transaction provides a *net benefit* to Canada. In deciding this, the Minister of Industry will consider the following factors:

- the effect of the investment on the level and nature of economic activity in Canada;
- the degree and significance of participation by Canadians;
- the effect of the investment on productivity, efficiency, technological development, product innovation and variety;
- the effect of the investment on competition in Canada;
- the compatibility of the investment with national industrial, economic and cultural policies; and
- the contribution of the investment to Canada's ability to compete in world markets.

Like Australia, Canada adopts a consultative process where potential investors work with the Canadian Government to iron out wrinkles in hopes of arriving at a mutually beneficial conclusion.

Since the ICA's enactment in 1985, out of over 1,500[14] non-cultural sector reviews undertaken, all were approved but for one. This block was against the US$1.3 billion acquisition of MacDonald Dettwiler and Associates' (MDA) information systems business by US company Alliant Techsystems (ATI). Reasons for the Minister's rejection are not publicly available due to strict confidentiality provisions under the ICA. However, news reports speculated that the main reason was borne out of a fear of losing Canadian control over strategic space technology. Although not expressly stated as a test in the ICA, the reason for the denial was tantamount to offending Canada's national security, a test that is made explicit in Australian legislation.

Veto of the ATI-MDA transaction came amid anxiety over the pace and increase in FDI flows into Canada via mergers and acquisitions (M&A) of hallmark Canadian companies, and the surrender of control to foreigners that followed. Sentiment concerning the "hollowing-out" of corporate Canada heightened when Chinese SOE China Minmetals Corporation (CMC) bid for mining company Noranda.[15] Though the bid was unsuccessful and issues of foreign SOE control over Canadian strategic assets were left unaddressed, CMC's attempt prompted parliament to query and examine the efficacy of its FDI review regime, which had approved all non-cultural applications that had passed through up till then. In this respect, economic pundits were quick to caution against any short-sighted protectionist measures.

The government's review led to the issuance of special guidelines in December 2007 concerning investments made by foreign SOEs (Canadian Guidelines) and the Competition Policy Review Panel's (Panel) June 2008 report titled "Compete to Win"[16], which included recommendations to increase Canada's competitiveness in the global market. Similar to its Australian counterpart, the Canadian Guidelines generally prescribe that the Minister will assess an SOE's adherence to standards of corporate governance should it wish to acquire control of a Canadian company.[17] This signalled a more restrictive stance on state-owned investment than before.

Fortunately, the Panel's report was an about-turn from where the Canadian Guidelines seemed to be heading, and was much needed positive reinforcement that Canada welcomes FDI. Lauding foreign M&As as competition to be embraced and encouraged, the Panel recommended that parliament:

- raise the review threshold from C$295 million (gross asset value) to C$1 billion (enterprise value), except for cultural industries;
- abolish the net benefit test and reverse the onus by having the Minister demonstrate that an investment is "contrary to Canada's national interest";
- remove sector-specific lower thresholds that trigger review, including transportation, uranium production and financial services;
- remove post-closing notification for investments that are under threshold review; and
- improve transparency and predictability.

The Panel's report is timely given the negative press generated in 2007 by PetroChina's withdrawal from a US$3.8 billion pipeline project that would have supplied crude oil to China from Canada's oil sands.[18] The retreat surprised Alberta-based partner Enbridge when a representative of China National Petroleum, PetroChina's parent, announced very publicly that "[t]he Canadian environment is not comfortable" and "Canada doesn't want to open up its own markets to us."[19] As such, the Panel's report provides refreshing clarity of where Canada's FDI compass should point. Current Canadian Prime Minister Stephen Harper has vowed to implement a number of the Panel's recommendations if a Conservative government is elected during Canada's upcoming federal election on October 14 2008.[20]

Canadian goodwill towards Chinese FDI can also be found in its on-going negotiations for the Canada-China Foreign Investment Promotion and Protection Agreement (FIPA), which began in September 2004. Finalising the FIPA is a priority for Canada especially if it is to direct some of China's ODI away from developing countries in Africa and South America.

FDI DIRECTION IN AUSTRALIA AND CANADA

Despite being richly-endowed with energy and resources – perfect matches for China's growing demand – Australia and Canada have yet to maximise their China ODI potential. Both jurisdictions have similar FDI review regimes that require prospective investors to seek project approval before proceeding and both have recently issued guidelines targeted at investments by SOEs. The new Australian government's difficulty with reaching a settled position on SOE investment in general is having a real impact on Chinese SOEs' ability to obtain approvals to invest in Australia.

Fortunately for Canada, a recent government-commissioned report serendipitously and unequivocally recommended measures to open up FDI, which helped counter the negative publicity brought on by the Canadian Guidelines. General sentiment from corporate Australia is that its government should do the same. It remains to be seen whether the Canadian government will incorporate all recommendations in its anticipated overhaul of the ICA and whether the Australian Government will follow suit with recommendations on how to improve its own FDI regime, but there is at least a strong understanding in both nations that neither can afford to ignore China's interests.

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Endnotes

1. National Statistics Bureau, "Statistical Communiqué for national and social development of the People's Republic of China for 2007" (February 28 2008) at http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20080228_402464933.htm
2. Foreign Affairs and International Trade Canada "Canada-China Fact Sheet" at www.international.gc.ca./commerce/markets-marches/factsheet-china-en.asp
3. Latest available official data from the People's Bank of China.
4. Mining Association of Canada "Positioning Canada for Continued Competitiveness in the Mining, Minerals and Metals Industry" (January 2008) p.2.
5. http://fec.mofcom.gov.cn/
6. *Ibid* p.1.
7. Government of Canada "Compete to Win" (June 2008), p.22 and 23.
8. Wu Shiqiang, *A Bright Future for the China-Australia Economic and Trade Cooperation*, speech at luncheon hosted by China Chamber of Commerce in Sydney on April 29 2008.
9. Summary of Australia's Foreign Investment Policy is available at www.firb.gov.au
10. Prescribed sensitive factors include media, telecommunications, transport, military matters, security technology and extraction of uranium or plutonium or the operation of nuclear facilities.
11. Principles Guiding Consideration of Foreign Government Related Investment in Australia, at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType.
12. The current FIRB Annual Report for 2006/7 at page 18 reports a rejection rate of less than 1%.
13. Cultural industries are businesses related to Canada's cultural heritage and national identity and include radio, television and other broadcasting activities.
14. This figure does not include applications that were submitted and subsequently withdrawn.
15. In 2005, Noranda merged with and continued operations under rival mining company Falconbridge Limited, which was later acquired by Swiss-based mining company Xstrata and Brazil-based Vale in 2006 for close to C$20 billion.
16. Final report available at http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/en/home.
17. These would include transparency and disclosure, independent directors, independent audit committees and equitable treatment of shareholders and compliance with Canadian laws and practices.
18. International Herald Tribune "PetroChina pulls out of Canadian oil sand pipeline development project, newspaper reports" (July 12 2007) at www.iht.com/bin/print.php?id=6639741.
19. *Ibid*
20. Globe and Mail "Harper promises to relax foreign investment rules" (September 12 2008) at www.globeandmail.com.