Chapter 4

Sovereign wealth funds and state-owned entities

4.1 The terms of reference for the inquiry directed the committee to examine both the international and Australian experience of sovereign wealth funds (SWFs) and state-owned entities (SOEs). In this chapter the committee turns to outline the recent emergence of SWFs and SOEs before then examining the effectiveness of Australia's regulatory system for managing foreign investment applications by sovereign wealth funds and state-owned entities.

4.2 In recent years the rapid accumulation of assets in various countries has resulted in the growing number of SWFs. SWFs have emerged as a key player in the international capital markets and SWFs are currently estimated to hold close to $US3 trillion in assets.[1] Evidence received by the committee suggested that their presence is set to grow with the IMF estimating that SWFs could grow to about US$12 trillion by 2012.[2] In their submission, Dr Malcolm Cook and Mr Mark Thirlwell, Lowy Institute for International Policy, referred to SWFs as a 'move towards state capitalism'.[3]

4.3 The Future Fund's Chairman Mr David Murray AO, explained from where the money contained in SWFs has been sourced:

> …75 per cent of the money in sovereign wealth funds, as far as I can assess it, is oil sourced, about 20 per cent export surplus sourced and about five per cent budget surplus sourced. Australia would be in that last category.[4]

4.4 Mr Murray also explained that some nations establish SWFs because they are resources dependant while others establish SWFs because they are export surplus countries. Resource dependent countries like the United Arab Emirates, Kuwait, Saudi Arabia, Norway and Brunei look to protect themselves from resource depletion by setting up significant SWFs for the long term.

4.5 Dr Brian Fisher, Concept Economics, referred to this as 'rents from exhaustible resources'. He suggested that these 'rents' could be used productively to

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1 As a consequence of the global financial crisis there has been growth in the number and size of SWFs. Rio Tinto's submission suggests that, since September 2008, at least 14 financial institutions have become either wholly or partly owned by SWFs, *Submission 47*, p. 34.

2 *Submission 56*, Appendix 2, Malcolm Cook and Mark Thirlwell, 'The Changing Global Financial Environment: Implications for Foreign Investment in Australia and China', Lowy Institute for International Policy, July 2008, p. 4.

3 *Submission 56*, Appendix 2, Malcolm Cook and Mark Thirlwell, 'The Changing Global Financial Environment: Implications for Foreign Investment in Australia and China', Lowy Institute for International Policy, July 2008, p. 4.

4 *Proof Committee Hansard*, 10 August 2009, p. 20.

ensure intergenerational equity through drawing on the annual output from the capital stock:

> There is a vast amount of economic literature on this very interesting subject that goes back a long time and, in fact, led the Norwegians to establish their oil investment fund. Basically, their view was that you can either have the oil in the ground and save it up until some point in the future or you can exploit it and put a proportion of the rent into some fund, invest the money and earn interest on the money. Under reasonable conditions those two things are potentially equivalent. Much of the economic literature talks about what is the optimal trajectory for the exploitation of a non-renewable resource such as oil.
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> The theory is relatively straightforward, but in the practical world where we have uncertainty about what future demand is for a particular commodity the practice is a little bit more difficult. In the case of iron ore, for example, it is unlikely that there is going to be, in the near term, lots of substitutes for steel, so we are going to end up using lots of iron ore into the future, and it just so happens, luckily, that there is lots of iron ore on the planet as well, so we are unlikely to run out of the stuff in the short term or even the very long term…
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> If, for example, you decide to store a product in the ground like oil and somebody turns up with a nice substitute, all of a sudden you are sitting on some black stuff that five years ago was very valuable and now all of a sudden is not very valuable at all…It is much more difficult to think about intergenerational equity than just saying that we will save the iron ore for future generations. It might actually be much more efficient to sell to the Chinese, Japanese and the Koreans iron ore today and put the rent in the bank or in your super fund, save it that way and then pass it on to future generations.[5]

4.6 The other category of SWF referred to by Mr Murray is that established by export surplus countries:

> In the case of export surplus countries, they simply arrive at a situation, for various reasons, where their foreign reserves are much larger than could normally be expected to be needed in their central bank for the normal reserve purposes…They often split their funds into either wealth funds or budget stabilisation funds, in addition to what is held for international purposes in the central bank…In Australia's case, we are working off favourable terms of trade over a considerable period in which we had budget surpluses and we have chosen to set those aside in the interests of better public sector savings specifically to deal with the likely budget situation from 2020 and beyond with ageing of the population.[6]

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5 *Proof Committee Hansard*, 10 August 2009, pp. 35–36.

6 *Proof Committee Hansard*, 10 August 2009, pp. 23–24.

4.7 At the Budget Estimates hearing of June 2009, Mr Patrick Colmer explained that FIRB had not identified any significant problems with SWFs in Australia:

> The experience that we have had with sovereign wealth funds goes back many years. There has been some very recent attention on sovereign wealth funds. Our experience over quite a few years has been that, generally speaking, we have not identified any problems with sovereign wealth funds in the way that they operate in Australia.[7]

Characteristics of SWFs

4.8 Mr David Murray—who along with being the Future Fund's Chairman of Board of Guardians is also Chairman of the newly formed International Forum of Sovereign Wealth Funds—suggested that their were three distinguishing features of a SWF:

- It has a defined special purpose;
- Its assets are held for the community and not individual interest; and
- It invests in financial assets.[8]

4.9 The International Working Group on Sovereign Wealth Funds draws attention to the status and behaviour of SWFs:

- In their home countries, SWFs are institutions of central importance in helping to improve the management of public finances and achieve macroeconomic stability, and in supporting high-quality growth;
- In many instances they take a long term view of investment and 'ride out' business cycles, bringing important diversity to global financial markets.[9]

Examples of Sovereign Wealth Funds

Abu Dhabi Investment Authority

4.10 Established in 1976, the Abu Dhabi Investment Authority's (ADIA) principal funding source is from a financial surplus from oil exports. The ADIA replaced the Financial Investments Board which was created in 1967 as part of the then Abu Dhabi Ministry of Finance. It is the largest SWF; it is wholly owned and subject to supervision by the government of Abu Dhabi. The fund is an independent legal identity with full capacity to act in fulfilling its statutory mandate and objectives. As much as 75 per cent of its assets are administered by external managers.

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7 *Economics Legislation Committee Estimates Hansard,* 4 June 2009, p. 10.

8 *Proof Committee Hansard*, 10 August 2009, p. 24.

9 International Working Group on Sovereign Wealth Funds: 'Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles"', October 2008, p. 3.

4.11 ADIA's funding sources derive from oil, specifically from the Abu Dhabi National Oil Company (ADNOC) and its subsidiaries which pay a dividend to help fund the ADIA and its sister fund Abu Dhabi Investment Council (ADIC). Established in 2006, the Abu Dhabi Investment Council has a local and regional focus and holds stakes in two large state owned banks, Abu Dhabi Commercial Bank and the National Bank of Abu Dhabi.[10]

Singapore's Temasek Holdings

4.12 Created in 1974, Singapore's Temasek Holdings is a SWF which primarily focuses on Asia and Singapore. Temasek holds significant stakes in the major corporations: Merrill Lynch, Barclays Bank and SingTel. (SingTel, who owns Optus is majority owned by Temasek Holdings, which holds 54 per cent of SingTel's issued share capital.) The Lowy Institute for International Policy suggests that Singapore has been the regional leader in 'creating new investment vehicles to manage the accumulation of a diversified portfolio of foreign assets'.[11]

China Investment Corporation (CIC)

4.13 The China Investment Corporation (CIC) was established in September 2007. Modelled on Singapore's Temasek Holdings, the CIC is responsible for managing part of China's foreign exchange reserves. It is responsible for managing China's $200 billion sovereign wealth fund. To date it has made substantial investments in financial firms. The previous vehicle, state-owned Central Huijin Investment Limited, was merged into the new company as a wholly-owned subsidiary company. Typically there is a separate entity that is interposed to manage investments on behalf of the CIC. The Lowy Institute for International Policy explains that two-thirds of the CIC's investment portfolio is expected to be targeted at recapitalising the domestic financial sector with only one-third for investment overseas, mostly through fund managers.[12]

Australian Government Future Fund

4.14 Established in 2006, the Australian Government Future Fund, or pension fund, is an independently managed investment fund into which the Australian government has deposited fiscal surpluses. The purpose of the fund is to meet the

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10 Sovereign Wealth Fund Institute, http://www.swfinstitute.org/fund/adia.php (accessed 23 April 2009).

11 *Submission 56*, Appendix 2, Malcolm Cook and Mark Thirlwell, 'The Changing Global Financial Environment: Implications for Foreign Investment in Australia and China', Lowy Institute for International Policy, July 2008, p. 4.

12 *Submission 56*, Appendix 2, p. 6. CIC deputy general manager, Wang Jianxi, (who is also a member of the National Committee of the Chinese People's Political Consultative Conference, the top political advisory body), recently stated that it was now a 'good opportunity' for the CIC to make international investments. 'China's sovereign wealth fund sees "good opportunity" for int'l investment', *Xinhua*, 11 March 2009: http://news.xinhuanet.com/english/2009-03/11/content_10992451.htm (accessed 23 April 2009).

government's future liabilities for the payment of superannuation to retired public employees. The stated aim of the fund is to hold $140 billion by 2020; this figure would free up $7 billion in superannuation payments each year from the federal budget.

4.15 The Future Fund was established by the *Future Fund Act 2006* to assist future Australian governments meet the cost of public sector superannuation liabilities by delivering investment returns on contributions to the Fund. Investment of the Future Fund is the responsibility of the Future Fund Board of Guardians with the support of the Future Fund Management Agency. From 1 January 2009, the Board of Guardians gained responsibility for the investment of the assets of the Education Investment Fund (EIF), the Building Australia Fund (BAF) and the Health and Hospitals Fund (HHF).

4.16 The Board is collectively responsible for the investment decisions relating to the special purpose public funds and is accountable to the government for the safekeeping and performance of those assets. As such, the Board's primary role is to set the strategic direction of the investment activities of the funds consistent with the Investment Mandate for each fund. The Board is supported in its functions by the Future Fund Management Agency. The Agency is responsible for the development of recommendations to the Board on the most appropriate investment strategy for each fund and for the implementation of these strategies. All administrative and operational functions associated with the management of the funds are undertaken by the Agency.[13] The Future Fund invests in an array of assets and as at 31 March 2009 the Future Fund assets (including Telstra shares valued at $6.8 billion) are $58.1 billion.[14]

4.17 Mr Murray was question by the committee as to whether the Future Fund may look to invest in resource and infrastructure projects within Australia into the future, to which he responded:

> To achieve our objective we need to invest in an array of assets. We do that by building a strategic asset allocation that, in our opinion, is likely to meet the return objective we have been given in our mandate from the government. We, therefore, need to have some diversity of assets but, given the type of return target we have, infrastructure investments will be an important component and Australian equities will be an important component. By investing in Australian equities we would be an important investor in Australian mining companies.[15]

4.18 The committee also notes that numerous submitters to the inquiry recommended that Australian entities, in particular the Future Fund and

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13 Future Fund website: http://www.futurefund.gov.au/ (accessed 3 August 2009).

14 Future Fund, 'Portfolio update at 31 March 2009', http://www.futurefund.gov.au/__data/assets/pdf_file/0016/3175/Final_Portfolio_update_31_March_09.pdf, 4 May 2009 (accessed 3 August 2009).

15 *Proof Committee Hansard*, 10 August 2009, p. 21.

superannuation funds, look to invest more in Australia's resource sector, arguing that this would reduce the sector's reliance on foreign capital.[16]

Largest Sovereign Wealth Funds (in US$ Billions)[17]

Country	***Fund(s)***	***Size***
UAE	Abu Dhabi Investment Authority	704
Norway	Government Pension Fund	379
Singapore	Government Investment Corporation/ Temasek Holdings	378
Saudi Arabia	No designated name	287
Kuwait	Revenue Fund for Future Generations/ Government Reserve Fund	222
China	China Investment Corporation	218
Russia	Reserve Fund/ National Welfare Fund	158
Australia	Australian Future Fund	101
Libya	Libya Investment Corporation	86
Algeria	Reserve Fund/ Revenue Regulation Fund	56
USA	Alaska Permanent Reserve Fund	50
Qatar	State Reserve Fund/ Stabilisation Fund	44
Brunei	Brunei Investment Authority	43
Korea	Korea Investment Corporation	31
Kazakhstan	National Fund	30

16 See, for example, Mr and Mrs I Voesenek, *Submission 18*; Mr Len Johnson, *Submission 43*, p. 1; Mr Arthur Johnson, *Submission 44*.

17 Adapted from 'Exhibit 19', Rio Tinto, *Submission 47*, p. 36.

International Working Group of Sovereign Wealth Funds and the Santiago Principles

4.19 The International Working Group (IWG) comprises 26 IMF member countries with SWFs.[18] They were formed to identify and draft a set of generally accepted principles and practices (GAPP) that properly reflect their investment practices and objectives. These investment practices and objectives have come to be embodied in the Santiago Principles. Mr David Murray informed the committee about the development of the Group:

> I would like to point to the history of development of that group. When there was first fairly serious concern in the US and Europe about investments from sovereign wealth funds into predominantly western countries the IMF, through its representative ministers, formed an international working group of sovereign wealth funds and set out to form an agreed standard of practices dealing with sovereign wealth funds, which eventually became the Santiago principles. Australia was a supporter of that process through its IMF representative minister, the Treasurer, and the guiding objectives for those principles were to help maintain a stable global financial system and free flow of capital investment to comply with all applicable regulatory and disclosure requirements in the countries in which sovereign wealth funds invest, to invest on the basis of economic and financial risk and return-related considerations, and to have in place transparent and sound governance structures.[19]

4.20 The Santiago Principles are the generally accepted principles and practices of the International Working Group of Sovereign Wealth Funds. As suggested above, the Santiago Principles were a response to pressure, particularly from the U.S. Congress, through the IMF, to create a set of principles which, if adhered to would give recipient countries of foreign investment comfort that those sovereign wealth funds acted more from commercial principles than any other principles. They also sought to provide a framework that reflects appropriate governance, accountability and transparency arrangements. Mr Murray added: 'The publication of those principles has gone a long way to placate some of the critics of sovereign wealth funds'.[20] There are 24 generally accepted principles and practices. These were established on 11 October 2008 and can be found at: http://www.iwg-swf.org/pubs/gapplist.htm.

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18 IWG member countries are Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Islamic Republic of Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad and Tobago, the United Arab Emirates, and the United States. Permanent observers of the IWG are Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank. International Working Group on Sovereign Wealth Funds: 'Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles"', October 2008, p. 1.

19 *Proof Committee Hansard*, 10 August 2009, p. 20.

20 *Proof Committee Hansard*, 10 August 2009, pp. 21–22.

International Forum of Sovereign Wealth Funds

4.21 In April 2009 the International Working Group of Sovereign Wealth Funds established the International Forum of Sovereign Wealth Funds through the 'Kuwait Declaration'. The Forum is a voluntary group of SWFs that seeks to provide the opportunity for SWFs to meet, exchange views on issues of common interest, and facilitate an understanding of the Santiago Principles and SWF activities. The Forum does not seek to be a formal supranational authority and its work does not carry any legal force.[21]

4.22 The purpose of the Forum is to act as a platform for:

- Exchanging ideas and views among SWFs and with other relevant parties. These will cover, inter alia, issues such as trends and developments pertaining to SWF activities, risk management, investment regimes, market and institutional conditions affecting investment operations, and interactions with the economic and financial stability framework;

- Sharing views on the application of the Santiago Principles including operational and technical matters; and

- Encouraging cooperation with investment recipient countries, relevant international organisations, and capital market functionaries to identify potential risks that may affect cross-border investments, and to foster a non-discriminatory, constructive and mutually beneficial investment environment.[22]

4.23 This has proved another endeavour to establish international frameworks for SWFs to help develop confidence across the international community.

Committee view

4.24 The committee notes that while concern has been expressed about the size and power of SWFs the evidence obtained by the committee does not point to any significant concern about the investments or behaviour of SWFs. By contrast, the majority of the concerns that were raised over the course of the inquiry related to the investment activities of state-owned entities. Some submitters classified SWFs and SOEs in the same terms. The committee saw this as problematic and recognised that, by and large, they represent two distinct types of investment activity.

4.25 While the committee welcomes the fact that organisations like the International Working Group of Sovereign Wealth Funds have sought to codify the behaviours of SWFs, through establishing a set of core principles related to

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21 International Working Group of Sovereign Wealth Funds, http://www.iwg-swf.org/mis/kuwaitdec.htm (accessed 18 August 2009).

22 International Working Group of Sovereign Wealth Funds, http://www.iwg-swf.org/mis/kuwaitdec.htm (accessed 18 August 2009).

governance, accountability and transparency, the committee believes that the best way for Australia to regulate the conduct of foreign investors (be they SWF, SOE or private commercial operator), is through developing robust domestic legislation.

State-owned entities

4.26 SOEs are distinguished from SWF by their institutional closeness to the state. SOEs are a legal entity created by a government to undertake commercial or business activities on behalf of the owner government. Like SWFs, SOEs may have access to funds that often exceed that available to private commercial interests and they may have levels of influence and power that extends beyond many large multinational companies. What distinguishes SOEs from SWFs are some of the features of SWFs outlined above. Moreover, the International Working Group of Sovereign Wealth Funds has also sought to distinguish SWFs from SOEs through the Santiago Principles in terms of their standards of public disclosure, governance frameworks and reporting requirements.[23]

4.27 Professor Peter Drysdale and Professor Christopher Findlay point out that there may be substantial variation in the character and operations of SOEs and that SOEs operate under a range of policy regimes:

> State-owned enterprises operate under different policy regimes in different countries. The regime under which Swedish state-owned enterprise operates may be different from that under which Chinese or Indian state-owned enterprise operates. Do these differences affect the impact of investment from these different sources? And the regime under which state-owned enterprise operates changes over time, as it clearly has changed and is changing in China. Do these changes need to inform the strategy that host countries might adopt towards FDI from this source?[24]

4.28 There is concern the foreign governments might not act in the same way as private investors—they may be more explicitly political in their behaviour and may seek to exert influence in ways that extend beyond seeking to protect their investment. Beyond concerns about the power, size and scope of SOEs, various submitters to the inquiry expressed concerns about the effect investment by SOEs may have on: corporate governance, competition and national security. These arguments are outlined below.

Corporate governance

4.29 There have been criticisms that operators of SOEs lack transparency and accountability. Board members may find themselves representing two sets of interests—those of the SWF/ SOE and those of the company on whose board they sit:

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23 International Working Group on Sovereign Wealth Funds: 'Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles"', October 2008.

24 *Submission 40*, p. 4.

> …if you have board members appointed by the foreign owned enterprise … (t)hat person may have divided loyalties towards the target company or the Australian company and the foreign country that appoints them. This notion of a separate legal entity is well established in our corporate law system, but it may not be so well established in other legal systems where if you sit as a board member you have a duty to that company solely. This issue of divided loyalties is being dealt with under corporate law in Australia, whereas the person may have those divided loyalties and it may be hard to pin those down.[25]

4.30 However, Fortescue Metals Group, who as outlined above, recently accepted a deal worth $650 million which saw Hunan Valin assume a 17.55 per cent stake in the company, informed the committee of steps they had taken to reduce or eliminate the prospect of any such conflict:

> …when Fortescue sought investment and got investment from Hunan Valin, we were quite clear to restrict their shareholding, their board positions and their ability to look through to our costs…So we were quite clear: yes, they could be on the board; yes, they could be part of discussions, but if it involved anything to do with our cost or pricing structure they would have to excuse themselves from the discussion and not be circulated with any of the relevant information…
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> The other thing that we did was ensure that the representative on our board was a specified person. The reason for that was some concern on our part that the Chinese can at times send a subordinate to fulfil the role, he can be difficult and then, when you have argued with them and argued with them, ultimately they say, 'Sorry, he wasn't really authorised to do that', and they pull him out and put somebody else in. Our view was that the way to control that was to make sure that it is actually the chairman of Hunan Valin who is on our board and that he is not allowed to send an alternate. That means that whatever he says he has to stand by.

4.31 Mr Tapp further explained that as a result of their investment they obtained the right to have one board member but were not allowed a representative on any of the subcommittees. Moreover, that as a condition of FIRB approval, Valin was required to sign up to Fortescue's code of conduct. While this would have been required under the Companies Act, because it was attached to the FIRB approval, it was given additional weight.[26]

4.32 Writing about Chinese SOEs, Dr Ann Kent has also raised concerns about both the differences in corporate culture and the enforcement of insider trading laws. In the first instance she explains: it is not simply that businessmen can become politicians without election but that the relationship between commerce and officialdom in China is much more complex and fluid than Australia. In the second, when referring to the proposed Chinalco acquisition of an interest in Rio Tinto, she

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25 Associate Professor Zumbo, *Committee Hansard*, 10 August 2009, p. 2.

26 *Committee Hansard*, 2 July 2009, p. 27.

suggests that while board members 'would be subject to our laws by virtue of their board positions and under Australian insider trading laws, the enforcement of such obligations is poor in both Australia and China'.[27]

4.33 By contrast, IPA suggests that while there has been a 'perception of risk' associated with SOEs, appropriate regulation would see that Australian interests are protected:

> In Australia an SOE only enjoys the same commercial environment as any other investor. And the Australian government maintains the right to appropriately regulate where there may be a perceived risk from an external SOE investor. For example, the government can do so by ensuring that the standards of corporate governance for firms listed on the Australian Stock Exchange are rigorous and prevent large controlling shareholders from looting the firm's assets or expropriating firm value from minority shareholders. Given appropriate corporate governance standards, large controlling shareholders need not pose any investment threat or any other type of threat to Australia. With appropriate shareholder protection all investment would be in the national interest.[28]

4.34 This position was reinforced by evidence provided by Mr Patrick Colmer who reiterated that all Australian law applies to equally to all investors:

> It is important to recognise that an investor in this country will be subject to the industrial law, to the environmental law, to the health and safety law. All the Australian laws apply equally to a foreign investor once they are established in the country as they do to any other company operating in this country.[29]

4.35 Dr Brian Fisher, Concept Economics, suggested therefore that it was up to Australia to develop adequate regulatory frameworks for foreign investors:

> What this really comes back to is ensuring that our domestic legislation holds everyone to the same playing field. It does not matter who owns the company just as long as the OH&S rules, environment rules and the competition rules—all of those things—apply to those entities equally and we make sure that there is no improper transfer pricing and so on. That really comes down to our domestic arrangements. In my view, this is more about domestic settings than it is about attempted control of the initial investment.[30]

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27 Ann Kent, 'No need to rush Rio Tinto deal', *Canberra Times*, 17 April, 2009, p. 13.

28 *Submission 32*, p. 2.

29 *Committee Hansard*, 22 June 2009, pp. 8–9.

30 *Proof Committee Hansard*, 10 August 2009, p. 33.

Competition

4.36 The committee also heard concerns about competition and market manipulation in instances where buyers gain control over the supply chain. In relation to Chinese investment in the Australian resource sector, there is criticism that the Chinese government will use pricing information obtained through their association with the target company in their future contract negotiations. Associate Professor Zumbo suggested that this could result in manipulation or discriminatory pricing, that:

> (i) benefit state-owned companies that are customers of the Australian target company, or (ii) benefit customers from the country sponsoring the sovereign wealth fund or which controls the state-owned companies. Such discriminatory practices would be detrimental to other customers of the Australian target company competing with those favoured customers from the country sponsoring the sovereign wealth fund or which controls the state-owned companies.[31]

4.37 Associate Professor Zumbo also raised concerns about patterned strategic acquisitions—whereby a SWF or SOE seeks to acquire a series of companies within the same sector in order to gain a controlling stake in certain sectors of the economy. This, he suggests, would limit or remove the freedom of action of those target companies to negotiate with competitors and may ultimately result in forcing up prices for domestic consumers. Beyond the domestic market, Associate Professor Zumbo suggests that 'the process of creeping acquisitions in the same sector on a global scale would pose a very real and considerable danger to competition and consumers around the world'.[32] Concern over patterned or creeping acquisitions in the resources sector was also raised by Mr William Edwards:

> The areas where they are showing most interest in buying our assets are those that involve inputs into their own economy, so that they are able to exercise a stranglehold. There is a consistency to the pattern of their investment elsewhere in the world, and that is to get a stranglehold on things, particularly natural resources.[33]

Committee view

4.38 The committee acknowledges that the legislation identifies a substantial interest is where a person, alone or together with any associate(s), is in a position to control not less than 15 per cent of the voting power or holds interests in not less than 15 per cent of the issued shares of a corporation. It also notes that the legislation identifies an aggregate substantial interest as an instance where one or more persons together with any associate(s), are in a position to control not less than 40 per cent of

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31 *Submission 38*, p. 3.

32 *Submission 38*, p. 5.

33 *Committee Hansard*, 1 July 2009, p. 24.

the voting power or hold interests in not less than 40 per cent of the issued shares, of a corporation.[34].

4.39 The committee also notes that if a SOE sought to acquire a series of companies within the same sector, in order to gain a controlling stake in certain sectors of the economy, then the ACCC could rule against successive acquisitions on the basis that they were anticompetitive. Section 50 of the Trades Practices Act prohibits mergers and acquisitions that would be likely to have the effect of substantially lessening competition in a market in Australia. The committee also believes that the Treasurer would also have the power to prevent such acquisitions if he believed they were against the national interest.

Benchmark pricing regime for iron ore

4.40 Prices for iron ore are largely determined by the benchmark pricing system, whereby producers negotiate with consumers and agree on a price that will prevail for the following year. Price is affected as much by supply and demand as it is determined by the effectiveness of the two parties' negotiating position. While participants often regard this system as flawed, and companies like BHP-Billiton have withdrawn from annual benchmark pricing negotiations, progress towards a more transparent market pricing system has been limited. Fortescue identified the repercussions this might have for partner/ buyers.

> The point I want to make about this is that having information about the cost structure of Australian entities could potentially be damaging to those undertaking benchmark negotiations. It is not clear how long the benchmark system will continue to run. But certainly our view is that for the Japanese joint ventures, to the extent that they have had a look through to mining costs, that has favoured them when it comes to the annual benchmark negotiations because they have an understanding of what the cost position of the person they are negotiating with is.
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> The issue at stake here is that, ultimately if uncommercial expansion takes place for the purpose of driving down the price, that will be damaging to Australia's national interest.[35]

4.41 In order to protect their interests, Mr Tapp explained that Fortescue were quite clear to restrict Hunan Valin's 'shareholding, their board positions and their ability to look through to our costs' and they (given the way the investment has been structured) 'see no threat'.[36] Therefore, to protect Fortescue's bargaining position in price negotiations, they limited Chinese access to price sensitive materials that may be used in benchmark pricing negotiations. Mr Tapp went further in identifying the way in which Fortescue have eliminated the capacity of the owner/ buyer to drive the price down:

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34 FIRB, *Annual Report 2007–08*, p. 45.

35 *Committee Hansard*, 2 July 2009, p. 28.

36 *Committee Hansard*, 2 July 2009, p. 28.

> As far as we are concerned, what was imposed on Hunan Valin was entirely consistent with our own corporate code of conduct and entirely consistent with the Corporations Act. If you are a director of a company, you have a duty to declare when you have a conflict of interest. If you are on that board representing the Chinese government or, indeed, a steel mill, you have a conflict of interest when it comes to negotiating the price. So we were quite clear: yes, they could be on the board; yes, they could be part of discussions, but if it involved anything to do with our cost or pricing structure they would have to excuse themselves from the discussion and not be circulated with any of the relevant information…
>
> I will be quite clear about what our fear is: investment in expanding production for the sole purpose of increasing supply to drive the price down. That is not something you can do unless you control the entity. It is not something you can do if you only control a very small entity.
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> Clearly, when large companies like Fortescue, Rio or BHP are involved, they are able to increase their production to the point where they can have a material impact on the overall supply situation. I would not want to see a situation where somebody else controlled them to the extent that they had the ability to demand that they expand production. Even though that would be bad for the company, it would ultimately be good for the customer. If you are the Chinese government and you own both the company and most of the steel mills, it can be in your interest to engage in such commercial activity.[37]

Committee view

4.42 The committee notes with interest the evidence offered by the Fortescue Metals Group and considers it a useful example of where conditions may be placed on SOEs where it is believed there is potential for some type of commercial conflict.

National security and geo-strategic concerns

4.43 The fifth principle contained in the Treasurer's Guidelines for Foreign Investment Proposals focuses on national security:

> An investment may impact on Australia's national security.
>
> The Government would consider the extent to which investments might affect Australia's ability to protect its strategic and security interests.

4.44 Recently the Treasurer ruled against the Minmetals $2.6 billion bid for OZ Minerals in March 2009 on national security grounds as the Prominent Hill copper/gold mine was deemed to be within the Woomera Prohibited Area of South Australia, a weapons testing range. Subsequently the terms of the deal were revised, omitting the Prominent Hill mine and the Treasurer approved the application.

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37 *Committee Hansard*, 2 July 2009, pp. 28–29.

4.45 With respect to Chinese investment in Australia, it is worth noting that traditionally Australia's most important trading partners have also been its security partners. They have also been democracies. Mark Thirlwell, Lowy Institute for International Policy, notes:

> A further important complication is (geo-) political. Traditionally Australia's most important trading partners have also been our key security partner (the UK and then the US)—or at least an ally of our key security partner (Japan), all of them democracies. Now for the first time our largest trading partner is authoritarian, a quasi-mercantilist, and a strategic competitor of our major ally.[38]

4. 46 Others submitters did not see the national security concerns explicitly linked to security. Rather they referred to the way in which Chinese acquisitions would result in a gradual erosion of Australian sovereignty. This concern has been outlined above.[39]

Additional concerns about Chinese SOEs

4.47 Many of the concerns related to Chinese foreign investment were similar to those related to foreign investment generally. These typically relate to issues of transparency; conflict of interest (wherein the seller becomes a buyer); loss of control over natural resources in a time of global resource scarcity; and concern over whether the Chinese government might not act in the same way as a private investor. China-specific concerns related to: the fact that Chinese SOEs are considered to be government controlled; the ceding of sensitive technologies to a potential military competitor; and the human rights record of the Chinese government and by extension its state-owned entities. The Leader of the Opposition, Malcolm Turnbull, has raised two further concerns: one related to the transfers of assets, the other related to matters of mutuality.[40]

4.48 Others have a more extreme position arguing that the operations of Chinese SOEs are part of a strategic campaign by a non-democratic nation to undermine the Australian economy and threaten Australian sovereignty. A number of submitters to

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38 Mark Thirlwell, 'Is the Foreign Investment Review Board acting fairly?', Institute of Public Affairs, AOIF Paper 4, p. 15, Lowy Institute for International Policy, *Submission 56*, Appendix 1.

39 For example, *Submission 38* (Associate Professor Frank Zumbo), p. 5.

40 '…it is worth noting that the transaction documents would allow Chinalco to transfer its interests in the operating joint ventures including the Hamersley iron ore mines to another Chinese Government state-owned enterprise' and 'There is no prospect that an Australian or any foreign company would be able to acquire a stake of this kind in a major Chinese resource company – not least because they are all state owned'. Malcolm Turnbull, 'Power Balance in Asia: The Coalition perspective', Address to the Lowy Institute, Sydney, 1 May 2009, p. 9. http://malcolmturnbull.com.au/Media/LatestNews/tabid/110/articleType/ArticleView/articleId/454/Power-Balance-in-Asia-The-Coalition-perspective-Address-to-the-Lowy-Institute.aspx (accessed 5 May 2009).

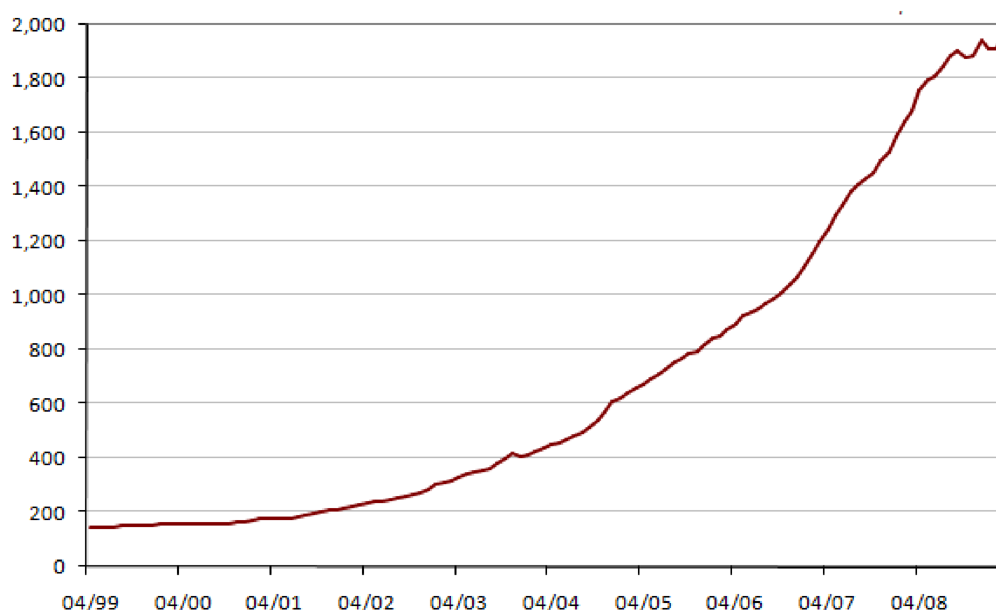
the inquiry articulated this strategic dominance/ Trojan horse thesis. The National Civic Council warned that China's emergence as a hegemonic economic power presents an acute challenge to Australia's national security and that Australia risks falling victim to China's strategic dominance through its foreign investment.[41]

Chinese capital and China's outbound investment

4.49 For some years the People's Republic of China (PRC) has been acquiring very significant foreign reserves. The PRC currently has around US$2 trillion in foreign exchange reserves in US currency or US Treasury bonds. In addition to the US$200 billion sovereign wealth fund, which is managed by the China Investment Corporation (CIC), China also has the National Social Security Fund (NSSF, $U.S. 80 billion). The NSSF collects pension contributions and the proceeds of state assets and has signalled that it would explore further investments offshore.

4.50 The Chinese market accounts for one third of global demand and two thirds of global demand growth in industrial metals. China consumes over a third of the world's aluminium, over a quarter of the world's copper and over half of the world's seaborne iron ore.[42] China's domestic iron ore resources cover less than 50 per cent of demand.

Chinese foreign reserves (US billions)[43]



4.51 Therefore, it is not surprising that China is considering ways of diversifying its investments through securing investment in the international resource sector. With so much money, at a time of scare global liquidity, the Chinese government is actively

41 *Submission 31*, p. 3.

42 Rio Tinto, *Submission 47*, p. 58.

43 People's Bank of China, as cited by the Sovereign Wealth Fund Institute, http://www.swfinstitute.org/ (accessed: 23 April 2009).

encouraging its domestic entities to diversify and explore overseas opportunities—particularly in the energy and resource sector. Resource-rich nations like Australia and Canada have become the focus of China's strategic efforts.

China's 'going out' strategy

4.52 China's recent foreign investment activity has been prompted by the announcement, at the Chinese Communist Party's Sixteenth Congress in 2002, that the Chinese leadership was encouraging Chinese companies to 'zou chuqu'—step out into the global economy, not only through exports, but also by investing overseas. Professor Peter Drysdale offered the following context for this strategy:

> They are undertaking this investment in the context of what is called in China a 'going out' strategy, which is a policy that released the controls on foreign investment abroad and encouraged Chinese enterprise to take up stakes in foreign companies and undertake foreign investment, and foreign investment has grown rapidly under that policy.[44]

4.53 Professor Drysdale went on to explain how China's State-owned Assets Supervision and Administration Commission of the State Council has been charged, since 2003, with devolving responsibility of SOEs; making SOEs implement corporate governance reforms and having SOEs conform to commercial market disciplines:

> Since 2003 the State-owned Assets Supervision and Administration Commission of the State Council, SASAC, in China has assumed the responsibility for exercising ownership of state owned enterprises on behalf of the Chinese government. SASAC has two important roles. It supervises the key state enterprises and their management; it exercises a monetary role in their profit and management performance. Its second important role is that it carries forward the reform of state owned enterprises. It has the responsibility for reforming state owned enterprises, the privatisation of state owned enterprises, their governance and their consolidation. All of these things are also a main responsibility for SASAC.[45]

4.54 Professor Drysdale's argument extended further suggesting that it was important for Australia to engage these enterprises because it offers an opportunity to influence them and introduce them to the Australian system.[46]

Commercial imperatives of Chinese SOEs

4.55 The committee received evidence that those Chinese companies seeking to invest in Australia display highly commercial orientations. The Australia China Business Council suggested that there is 'growing evidence that corporate China is

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44 *Committee Hansard*, 1 July 2009, p. 29 and *Submission 52* and *52a*.

45 *Committee Hansard*, 1 July 2009, p. 30.

46 *Committee Hansard*, 1 July 2009, p. 38.

behaving commercially, or, as the Chinese would say, they are following a policy of "*zhengqi fenkai*"—proper separation of government functions from business operations'.[47] In speaking of his personal experience dealing with Chinese SOEs Mr Douglas Ritchie, Rio Tinto, explained:

> I have to say that not only do I find them commercial in their approach but I find that their standards, in terms of employment, occupational health and safety and attitudes to environment, are every bit as good as those of equivalent corporations elsewhere. I would also say that I have found that the people who manage these corporations manage them in exactly the same way as people like me manage our own corporations and they are judged in exactly the same way. That has to do with return on investment and the standards that one maintains that relate to the standards that the corporation itself sets. So I think that a lot of these fears that you express, Chair, as being around the place come from primarily, and unfortunately, a lack of familiarity with these state owned enterprises by the people who are making these comments.[48]

Chinese investment in Australia by industry, as approved by the Foreign Investment Review Board (FIRB) 1992–2007[49]

Year	Number	Agriculture, forestry and fisheries ($A million)	Manufacturing	Mineral exploration and resource processing	Real estate	Services and tourism	Total
1993–94	0	0	0	0	0	0	0
1994–95	927	0	1	42	426	52	522
1995–96	267	0	6	52	137	31	225
1996–97	102	10	3	5	176	17	210
1997–98	0	0	0	0	0	0	0
1998–99	0	0	0	0	0	0	0
1999–00	259	35	5	450	212	10	720
2000–01	0	0	0	0	0	0	0
2001–02	237	0	47	20	234	10	311
2002–03	0	0	0	0	0	0	0
2003–04	170	0	2	971	121	5	1,100
2004–05	206	2	0	39	181	42	264
2005–06	437	0	223	6,758	279	0	7,259
2006–07	874	15	700	1,203	712	11	2,640

47 *Committee Hansard*, 2 July 2009, p. 3.

48 *Committee Hansard*, 1 July 2009, p. 45.

49 Adapted from Professor Peter Drysdale and Professor Christopher Findlay, 'Chinese Foreign Direct Investment in Australia: Policy Issues for the Resource Sector', *Submission 40*, p. 10.

4.56 The committee also received evidence that characterised Chinese companies very differently. The National Civic Council suggested:

> …Chinese corporations—at least government-owned corporations—are not only government owned but these corporations are overwhelmingly state-run monopolies in which the key positions are appointed not just by the government but by a sole party which runs the government, which is the Chinese Communist Party.[50]

4.57 Referring to the size of China's SWF, the Farmers from the Liverpool Plains suggested that the Chinese government were 'wandering around the world…picking the eyes out of pretty well anything they can find and having a go at purchasing it'.[51]

Regulation of SOEs

4.58 Australia's guidelines for assessing foreign investment applications by foreign governments are similar to those for private sector proposals; however, they do identify some differences. In a February 2008 statement titled, 'Government improves transparency of foreign investment screening process' Treasurer Swan stated:

> Proposed investments by foreign governments and their agencies (for example, state-owned enterprises and sovereign wealth funds (SWF)) are assessed on the same basis as private sector proposals. National interest implications are determined on a case-by-case basis.
>
> However, the fact that these investors are owned or controlled by a foreign government raises additional factors that must also be examined.
>
> This reflects the fact that investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that could be contrary to Australia's national interest.
>
> The Government is obliged under the *Foreign Acquisitions and Takeovers Act 1975* to determine whether proposed foreign acquisitions are consistent with Australia's national interest.[52]

4.59 The committee received varying evidence related to the government's guidelines for assessing investment by sovereign wealth funds and state-owned entities. Professors Drysdale and Findlay raised concern about the government's new guidelines arguing that 'the elaboration of these principles was somewhat damaging to

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50 *Committee Hansard*, 23 June 2009, p. 8.

51 *Committee Hansard*, 1 July 2009, p. 3.

52 Treasurer Wayne Swan , 'Government improves transparency of foreign investment screening process', http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=2008&DocType=0 (accessed 18 August 2009).

Australia's foreign investment climate'. They suggest that the government's statement that 'investors owned or controlled by a foreign government raise additional factors that must also be examined', has the effect of discriminating specifically against Chinese investment proposals and creates uncertainty about Australia's foreign investment policy. Moreover, that through creating a class of investments which require special scrutiny Australia has departed from a 'well-established and respected case-by-case approach'.[53] Rio Tinto had a different view explaining it 'supports the six principles set out by the Treasurer in February 2008 for screening investments linked to foreign governments'.[54]

4.60 The committee received strong evidence suggesting that the government must act to ensure the appropriate legislative and regulatory frameworks are in place for assessing applications from SOEs. The IPA suggested:

> Rather than fearing investment from SOEs, the Australian government should be: ensuring the appropriate legislative and regulatory frameworks are in place to ensure investors act appropriately; and liberalising the Australian investment regulatory regime to ensure Australia is an attractive destination for investment capital.[55]

4.61 In its submission, the Lowy Institute for International Policy explained that while they view the emergence of new sources of foreign capital as positive for Australia they believe that a greater degree of regulatory oversight is required in the case of foreign investment by government-controlled entities:

> In our judgment, the present regulatory and policy framework for foreign investment applications is robust enough to manage this growing trend and provides a reasonable balance between Australia's openness to foreign investment and the responsibility of the government to ensure that economic and commercial change in Australia is in line with community interests and concerns. This framework's long-standing distinction between private sector foreign investment and investment originating from state-owned entities is both justifiable…[56]
>
> We also believe, however, that a greater degree of regulatory oversight in the case of foreign investment by government-controlled entities compared to that applied to private foreign investment is warranted.[57]

4.62 Arguing that as Australia seeks new forms of capital investment from overseas it needs to come to terms with applications from state-owned entities, Professors Drysdale and Findlay suggested:

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53 *Submission 40*, pages 33, 25, 27.

54 *Committee Hansard*, 1 July 2009, p. 44.

55 *Submission 32*, p. 2.

56 *Submission 56*, p. 2.

57 *Submission 56*, p. 2.

> There is no reason in principle why state-owned foreign firms will not deliver benefits to Australia or other host countries to foreign investment of a kind that is similar to those delivered by private owned foreign corporations. Technological advantages, management know-how, market ties, capital costs or other advantages that come with FDI can be associated with state-owned firms and support their competitiveness and viability in the same way as they do with private multinational corporations. It would therefore be unusual if the ownership of foreign investors was germane to approval of their investment. In seeking to secure supplies and establish relationships that are important to integrated operations across a resource supply chain or to exploit marketing advantages, an investment involving state ownership would be behaving no differently than many privately owned investments.[58]

4.63 By extension, they posit that 'there are no issues that cannot be dealt with under the umbrella test of national interest in managing the growth in Chinese FDI into the Australian minerals sector'.[59] Professors Drysdale and Findlay identify three main 'additional factors' that could demand a test of suitability beyond the 'national interest':

- FDI investments involving state ownership and dominant shareholding and control might be used to serve as a vehicle for shifting profits back to the home country through underpricing exports.
- FDI investments involving state ownership and dominant shareholding and control might be used to serve as an instrument for subsidising the development of 'excess capacity' or 'extra-marginal' projects and ratchetting resource prices down.
- FDI investments involving state ownership and dominant shareholding and control might be used to pursue political or strategic goals inconsistent with the efficient development and marketing of national resources.

4.64 However, they conclude that in each case a 'national interest' test provides adequate protection.[60] Dr Malcolm Cook, Lowy Institute for International Policy, similarly stated:

> …we think the existing regulatory framework before an investment review board and within that the differentiation made between private sector for an investment into Australia above 15 per cent and foreign investment by state owned entities is justified. Our basic view is that it is not broken so there is no real need to fix it.[61]

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58 *Submission 40*, p. 11.

59 *Submission 40*, p. 1.

60 *Submission 40*, pp. 25–26.

61 *Proof Committee Hansard*, 10 August 2009, p. 13.

4.65 This perspective was reiterated by Mr Mark Thirlwell, Lowy Institute for International Policy:

> It is not clear to me what falls through the gaps of the existing system, what additional tool we would need or what additional review processes we would need that is not already provided for in the existing framework.[62]

4.66 Mr Stephen Creese, Rio Tinto, also offered the following advice for determining the independence of SOEs

> We think there is a subset of questions that really need to be asked about independence from the government from which the state owned enterprise springs. We say you have to go down to the real nitty-gritty questions of control. Can the state owned enterprise actually control operating assets through its investment? Can it actually influence and control key business decisions about such things as capital investments, product mix, production levels, pricing, contracting strategies, marketing and those things? You need to go down to that level of detail. If you answer, 'Yes, they can', then you have got to say, 'Now we understand the detail of how that might work in the context of that particular transaction, is this contrary to the national interest in terms of the way that would operate?' So we think there is a more detailed level of inquiry than simply looking at: is it 'independent'?[63]

4.67 While suggesting that there was no need for wholesale conceptual reform, the Australia China Business Council suggested that the Foreign Acquisitions and Takeovers Act should be tightened so that:

> …the policy requirements in relation to investments by SWFs and SOEs (are incorporated) into the body of the Foreign Acquisitions and Takeovers Act to avoid arguments that the policy requirements may be beyond the ambit of the FATA…[64]

4.68 By contrast, the committee also heard several calls for the reform of FIRB and for increasing the regulation of foreign investment by SOEs. These included:

- Establishing an authority that is separate from the FIRB to control and administer the investment of sovereign funds into Australia, especially into the mining and resource sector.[65]
- Abolishing the case-by-case approach to better manage creeping acquisitions by SOEs.[66]

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62 *Proof Committee Hansard*, 10 August 2009, p. 15.

63 *Committee Hansard*, 1 July 2009, p. 47.

64 *Committee Hansard*, 2 July 2009, p. 3.

65 Mr Norman McNally, *Committee Hansard*, 2 July 2009, p. 20.

66 Mr William Edwards stated: 'would, I think, abolish the case-by-case approach to the review of foreign investments, because I think that all that leads to, ultimately, is creeping takeover of our assets', *Committee Hansard*, 1 July 2009, p. 23.

- Establishing more restrictive caps on foreign acquisitions/ ownership within specific strategic sectors (the mining industry, prime agricultural land) where a certain percentage of capitalisation should not exceed a certain level.[67]
- Giving FIRB to power to examine licenses issued by state governments.[68]

Committee view

4.69 Historically, one of the reasons Australia has relied upon foreign investment is because it has had shallow domestic capital markets. This continues to be the case particularly when it comes to capital intensive sectors such as the mining industry. The committee considers that it is critical that Australia continue to be seen as a country that welcomes foreign investment and remains an attractive and competitive place to invest. The committee believes that foreign investment is critical to the development of Australia's industries and infrastructure and has significant benefits for the Australian community at large.

4.70 The committee also believes that the best way for Australia to manage the new capital flows that have stemmed from the emergence of SWFs and SOEs is through developing robust domestic legislation. The committee has acknowledged that the FATA legislation could be tightened to deal with complex acquisitions where takeovers of smaller strategic assets may be masked by an application which, in total, does not represent more than 15 per cent, and therefore does not trigger review. As suggested above, the committee would like FIRB to give adequate consideration to the interaction between the various components of a total acquisition.

4.71 As has been suggested throughout this chapter, much of the evidence received by the committee argued that the current system for assessing foreign investment applications is adequate. Nevertheless, the committee also heard a range of other opinions which suggested that the current system was either too restrictive or not restrictive enough. The committee notes that while the Treasurer's recent announcement to increase the thresholds for reviewing applications from $100 million to $219 million may be welcomed by those seeking a more liberal foreign investment regime; it will be of serious concern to others. The committee notes that those who are critical of the current system, and who would like the thresholds for reviewing foreign investment applications lowered, have particular concern over how these higher thresholds may be used to assist companies or state-owned entities acquire assets in a patterned or strategic manner which may give them an opportunity to engage in the manipulation of pricing, particularly in the resource sector.

4.72 The committee believes that the current regulatory framework for assessing foreign investment proposals, whether they are made by private commercial interests,

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67 For example, Mr William Edwards, *Committee Hansard*, 1 July 2009, p. 23; Mr Ian Melrose, *Committee Hansard*, 10 August 2009, p. 25; Farmers from the Liverpool Plains, *Committee Hansard*, 1 July 2009, p. 14.

68 Farmers from the Liverpool Plains, *Committee Hansard*, 1 July 2009, p. 8.

sovereign wealth funds or state-owned entities, is sufficient. The committee considers that the combined powers of the *Foreign Acquisitions and Takeovers Act 1975*, *Foreign Acquisitions and Takeovers Regulations 1989, Trade Practices Act 1974* and laws related to transfer pricing and environmental and worker protection, are sufficient to provide for the robust assessment of foreign investment applications and satisfactory regulation of the conduct of foreign investors. The committee is also of the belief that, having considered all the evidence, the system of case-by-case assessment, based on the national interest, has also served Australia well.

Senator Alan Eggleston
Chair