

Parliament of Australia

Senate Economics Committee

**Inquiry into foreign investment
by state-owned entities**

**Submission
by**

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April 2009

Foreign investment by sovereign wealth funds and state-owned companies:

The dangers from a corporate governance, competition and the national security perspective

Foreign investment by sovereign wealth funds and state-owned companies raises substantial concerns from a corporate governance, competition and national security perspective.

Central to these concerns is the level of control or influence the sovereign wealth funds and state-owned companies will exert on Australian target companies and on markets in which those target and state-owned companies operate.

Corporate governance dangers

From a corporate governance perspective sovereign wealth funds and state-owned companies raise serious concerns regarding the general lack of transparency and accountability of sovereign wealth funds and state-owned companies. Sovereign wealth funds and state-owned companies are generally operated by their respective Governments in a secretive manner that prevents scrutiny of the size, source and management of funds and state-owned companies. Secrecy also generally surrounds the investment and other objectives of the funds or the state-owned companies. Little is generally known of the internal operation of the funds or the state-owned companies, as well as the actual or potential relationships between the management of the funds/companies and individual members of the Government or other Government agencies, especially the intelligence and/or military services of the countries sponsoring the funds/companies. A further unknown typically relates to the holdings that sovereign wealth funds and state-owned companies have in target companies around the world.

This general lack of transparency surrounding the operation and management of sovereign wealth funds and state-owned companies raises concerns given that such sovereign wealth funds and state-owned companies are increasingly taking controlling or influential interests in Australian target companies in strategic industries such as energy and resources. Indeed, allowing sovereign wealth funds and state-owned companies to take controlling or influential positions in Australian target companies means that the future direction of the Australian target companies in those strategic industries will be determined by persons or entities whose agendas and objectives are not publicly known and whose agendas and objectives may be inconsistent or even detrimental to the other shareholders, as well as to suppliers and customers of the Australian target company.

In particular, the board representatives or seconded employees associated with sovereign wealth funds and state-owned companies are most likely to have “divided” loyalties. While serving the Australian target company those board representatives and seconded employees will no doubt be mindful of their links with the sovereign wealth funds and state-owned companies and may consider that acting in the interests of sovereign wealth funds and state-owned companies when making corporate decisions will always be consistent with the best interests of the Australian target company. Such a mindset may place other shareholders and customers of the Australian target company at a considerable disadvantage, particularly where the other shareholders or customers may be competitors to the sovereign wealth funds and state-owned companies.

In short, there is a clear risk that the legal concept of an Australian target company being a separate legal entity may not be well understood or strictly adhered to by persons or entities closely linked to a sovereign Government through sovereign wealth funds and state-owned companies.

Competition dangers

Allowing sovereign wealth funds and state-owned companies to take controlling or influential positions in Australian target companies raises competition concerns at various levels.

First, allowing sovereign wealth funds and state-owned companies to take controlling or influential positions in Australian target companies enables the sovereign wealth funds and state-owned companies to influence or determine the pricing practices of the Australian target companies. Dangerously for competition this influence could lead to the Australian target company implementing discriminatory pricing practices 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.

The ability of the sovereign wealth funds and state-owned companies to use their control or influence of an Australian target company to raise the costs of competitors to the state-owned companies is detrimental to competition as it adversely impacts on the ability of those competitors to vigorously compete in the market place. This dampening of competition can lead to higher prices for consumers.

Second, competition can be also be dampened where, for example, the state-owned company acquisition of a controlling or influential position in the Australian target company is part of a strategy to vertically integrate. Thus, if a state-owned company is a steel producer the state-owned company may take a controlling or influential position in Australian target companies that mine the

raw materials needed for steel production. In doing so, the state-owned company would considerably strengthen its position to raise steel prices as it has locked up Australian suppliers of the raw materials to the detriment of other competing steel producers who may no longer be able to obtain competitively priced raw material supplies from the Australian target company.

There is also the further concern that once Australian target companies are locked up by a state-owned company it certainly reduces or removes any countervailing power that the Australian target company would otherwise have in negotiations to secure an economic return for the raw materials it sells to the state-owned company. This depresses returns to other shareholders and would require the Australian target company to recoup the lower returns from contracts with the state-owned companies by raising prices to other customers of the Australian target company, especially domestic customers. In practice, this may mean that while the state-owned company secures lower prices from the Australian target company it controls, Australian domestic customers of the Australian target company may face higher prices. This cross-subsidisation distorts competition and may lead to domestic consumers paying higher prices.

While this locking up of the Australian target company may considerably depress (i) the prices received by the target company for the raw materials from the state-owned company, and (ii) the returns to other shareholders of the Australian target company, it won't necessarily lead to lower steel prices as the acquisition may substantially enhance the market power of the state-owned company. In turn, this allows the state-owned company to raise steel prices to the detriment of consumers. In short, allowing state-owned companies to acquire Australian target companies as part of a vertical integration strategy can lead to a transfer of wealth from other shareholders of the Australian target companies to the state-owned company with considerable detriment to consumers who would face higher prices.

The detriment to competition and consumers would be increased considerably if the sovereign wealth funds and state-owned companies engaged in a pattern of acquisitions to secure controlling or influential positions in Australian target companies across a particular sector. Thus, if a state-owned steel company from a particular country started acquiring shareholdings in several or all of the Australian target companies involved in supplying raw materials for steel production there would be an even greater danger to competition and consumers as the locking up of a group of Australian target companies in the same sector would limit or remove the freedom of action of those target companies to negotiate with competitors of the state-owned steel company. Again, this would substantially enhance the market power of the state-owned company and its ability to raise prices.

Such market power could quite easily be increased to global monopoly levels if the state owned company was engaging in a world-wide pattern of acquisitions to secure controlling or influential positions in target companies in the same sector around the world. This 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, particularly if such acquisitions continue to be in strategic industries such as energy and resources - two sectors that lie at the heart of all economies and which are critical the economic prosperity of Australian consumers.

National security dangers

Given the scale of proposed acquisitions it is clear that sovereign wealth funds and state-owned companies have access to sums of money far in excess of any sums able to be generated by private commercial interests. In turn, this gives sovereign wealth funds and state-owned companies a level of a power and influence that surpasses that of even the largest multinational corporations or private equity investors. Clearly, there will a real danger that sovereign wealth funds and state-owned companies will seek to exert that power and influence in ways that go beyond merely protecting their investment in an Australian target company.

Indeed, there is a very real danger that there will be a blurring of the line between an Australian target company remaining a good corporate Australian citizen once it comes under the control or influence of sovereign wealth funds or state-owned companies and that Australian target company becoming a mouth piece of the country with which the sovereign wealth funds and state-owned companies are associated. This danger is heightened considerably and dangerously where the sovereign wealth funds and state-owned companies are linked in any way to the foreign country's military or security agencies.

The ultimate risk associated with sovereign wealth funds and state-owned companies is that they may use their power and influence in a manner contrary to the national interest of Australians or in a manner that seeks to influence Australian foreign or domestic policies. In short, sovereign wealth funds and state-owned companies should not in any way be allowed to threaten or undermine Australia's sovereignty.