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Foreign investment and the Australia United States Free Trade Agreement

This is one of a number of Information and Research Services Products being developed to address various facets of the proposed Free Trade Agreement and which will be progressively released over coming weeks.

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Contents

Introduction 1
Australian and US perspectives 2
Australian and US objectives 3
Implications 5
Case study 6

Introduction

On 8 February 2004 the Minister for Trade, Mark Vaile, announced that Australia had entered a free trade agreement with the US, the Australia United States Free Trade Agreement (AUSFTA). There was a simultaneous announcement by the US of a free trade agreement with Australia. The full text was released on 4 March 2004. Most of the discussion since the announcement has focused on issues to do with access for goods and services in the respective markets. However, there were also important announcements made with respect to foreign investment matters. Included here were the lifting of the automatic approval thresholds from $50 million to $800 million for takeovers of Australian companies in non-sensitive areas.

Agreements among countries on foreign investment have become more common in recent years. In a special chapter on foreign investment in a recent OECD Economic Outlook the OECD noted that formal agreements on foreign investment 'are far less extensive' than agreements on international trade despite the importance of foreign investment to the world economy. The agreements that the OECD cites as treating foreign investment include the North American Free Trade Agreement and recent agreements reached by Singapore and the European Fair Trade Association, Japan and Australia, the European Community and Chile, and among European countries under the European Union. Since that was written, Australia and Thailand concluded a free trade agreement that included some investment provisions. In addition mention should be made of the 1980s Australia New Zealand Closer Economic Relations agreement which includes investment facilitation and promotion measures.

The OECD also gives some quantitative research on the restrictiveness of the various regulatory regimes that deal with foreign investment in the 28 OECD countries. The OECD ranks countries in terms of their restrictiveness and, on that basis, suggests that Australia is much more restrictive than the US. For example, the US with a rank of 0. 17 is the 15th most restrictive of the 28 while Australia with a rank of 0. 27 is the 5th. (Ranking goes from least restrictive at zero to most restrictive at one.) This research suggests that Australia, being the heavier regulator, may well have more obligations to make concessions. However, to a large extent the OECD exercise compares apples and pears. The US comes out with a higher score on absolute limits on foreign ownership but lower on screening and restrictions on foreign personnel and operational freedom. Australia's screening could be seen as hardly worth worrying about compared with absolute limits on foreign ownership in communications and other sectors of the US economy.

The OECD itself has been particularly active in promoting investment agreements. For example, the OECD sponsored the Code of Liberalisation of Capital Movements under which 'countries bind themselves to agreed measures liberalising capital movements.' However, the individual country reservations in this document suggest that most existing restrictions were retained by member countries. Earlier attempts by the OECD to promote the Multilateral Agreement on Investment (MAI) failed as a result of international protest,

from groups such as Friends of the Earth, suggesting the MAI was undemocratic and would erode environmental safeguards. On 2 November 1998 the Assistant Treasurer, Senator Rod Kemp, announced that the MAI would not go ahead and cited 'a number of serious concerns with the draft text of the treaty as it stood.' Against this background it is important to examine the present provisions in further detail.

Australian and US perspectives

Each party to the agreement gave different emphasis on the content of the agreement. The United States side, through the Office of the US Trade Representative, has said that the agreement 'will establish a predictable framework for US investors operating in Australia. All forms of investment are protected under the Agreement, including enterprises, debt, concessions, contracts and intellectual property.' The Australian side is silent on exactly what is protected and how.

The Australian statement says the Agreement 'successfully preserves the main features of Australia's foreign investment policy' and refers to the lifting of the screening threshold from $50 million to $800 million. Screening presently applies to all types of foreign investment, the creation of new business and the takeover of existing companies. The US side refers to those limits as applying just to acquisitions in 'nearly all sectors' and also says:

> **All** U. S. investment in **new** businesses is exempted from screening under Australia's Foreign Investment Promotion (sic) Board (FIRB). (emphasis added)

The exemption of all US investment in new businesses seems inconsistent with a press release put out on Sunday 8 February 2004 by the Minister for Trade, Mark Vaile, who said:

> The right to examine significant foreign investment proposals in all sectors, to ensure they do not raise issues contrary to the national interest, is retained.

On 10 February 2004 the Treasurer, Peter Costello, told the Parliament that:

> In relation to foreign investment, Australia has protected sensitive areas, it has protected its national interest test, but it has liberalised the overall prospects for US foreign investment in Australia. We have liberalised it in relation to new investments and we have liberalised it outside sensitive sectors for existing areas up to a limit of $800 million, where we will not apply a screening test.

The Treasurer's response can be seen as consistent with the position put by the US although the statement is slightly opaque. Now the agreement is available it is apparent that there are no saving provisions that would allow screening of new businesses by US investors.

Australian and US objectives

The Australian Government had recently published its objectives for the free trade agreement generally and the foreign investment objectives included:

> Look for opportunities to reduce any unnecessary impediments that licensing requirements, standards or other regulations in the United States impose on Australian investors.

However, it would appear that the Australian Government was not able to win any concessions for Australian investment in the US, or at least none that it thought worthy of announcing. That may seem unfortunate given the problems experienced by foreign investors in the US. For example, the European Commission (EC) publishes an annual report on US barriers to trade and investment. In that report the EC has expressed concern about 'the current significant restrictions to foreign investment.' The EC mentions the *Exon-Florio Amendment to the Defence Production Act* that authorises the President to investigate any takeover or merger that could result in foreign control of an entity engaged in interstate commerce. The screening is carried out by the Committee on Foreign Investment in the US (CFIUS) in the Department of Treasury. The EC cites lengthy processes and legal costs connected with such investigation and, while the US concern is 'national security,' that term is open to wide interpretation. Moreover, there is no provision for review or compensation.

According to Washington based law firm, Gardner Carton & Douglas LLP:

> Every transaction that results in foreign ownership, control or influence over a U. S. company, or that results in a change in foreign ownership, control or influence, is potentially reviewable by CFIUS.

To take just one illustration, ASML Holding (ASML), a Dutch company, was blocked in its acquisition of Silicon Valley Group (SVG) until it agreed to numerous conditions imposed by the CFIUS. According to Gardner Carton and Douglas LLP, ASML had to:

- agree to divest itself of a subsidiary that supplied satellite parts
- commit that it would not relocate operations offshore, and
- agree that it would maintain its technology at cutting edge.

While the first condition appears to have something to do with US national security, the next two seem problematic.

Apart from the *Exon-Florio Amendment* the EC expresses concern about many US laws that give rise to 'conditional national treatment' which refers to treatment of foreign-owned firms that is less favourable than the treatment of domestic firms. In addition the

EC expresses concern about restrictions in particular industries such as shipping, power and communications.

While the present set of US restrictions on foreign investment remain, Australia successfully resisted pressure for further concessions to foreign interests in Australia. American business interests were pushing for 'investor-state dispute settlement' which is described as 'a mechanism for redressing unfair treatment by governments.' In other free trade agreements signed by the US American companies have the right to take the host government to a 'neutral' tribunal and gain compensation in the event of nationalisation or expropriation of US interests or measures having equivalent effects to nationalisation or expropriation. Depending on how the agreement is written investor-state arbitration can imply that there are remedies available for US owned businesses in Australia that are not available to any other business in Australia. Moreover, there was concern that the tribunals may give a wide interpretation to phrases such as 'measures having equivalent effects to nationalisation or expropriation.' The Australian Conservation Foundation for example was concerned that the agreement might have provided 'unprecedented rights to US corporations to challenge existing Australian laws that are designed to protect the environment and other matters of public interest.'

Despite the apparent victory for the Australian side, the Office of the US Trade Representative noted that while the two countries agreed not to adopt investor-state dispute settlement measures, the issue 'will be revisited if circumstances change.' The present draft of the agreement does include an article on expropriation and compensation (article 11. 7 on page 11-3) and measures equivalent to expropriation and compensation. While there are no investor-state dispute settlement mechanisms in the agreement as it stands there is provision for developing such procedures in the event of 'a change in circumstances.' Article 11. 16 par 1 says:

> If a Party considers that there has been a change in circumstances affecting the settlement of disputes on matters within the scope of this Chapter and that, in light of such change, the Parties should consider allowing an investor of a Party to submit to arbitration with the other Party a claim regarding a matter within the scope of this Chapter, the Party may request consultations with the other Party on the subject, including the development of procedures that may be appropriate. Upon such a request, the Parties shall promptly enter into consultations with a view towards allowing such a claim and establishing such procedures.

That seems to be saying that if Australia were to change its approach to US investors and a US corporation had a complaint, the US Government may press the Australian Government to agree to a procedure for the US corporation to put its claim. Against that, however, there is only a commitment for Australia to consult under those conditions.

Implications

One of the major questions raised by the investment clauses is how important this would be in practice and how many Australian businesses might be subject to potential takeover by US companies without FIRB screening. According to the Australian stock exchange there were 1472 companies listed on the stock exchange on 30 December 2003, of which 66 were foreign owned and 1406 were domestic companies. The AUSFTA would exempt US interests from FIRB examination for companies with assets worth under $800 million. Based on market valuations on Friday 6 February 2004, all but 147 companies would no longer need to be examined in the event of a takeover. Of course, many of those 147 companies are already foreign owned or controlled, including News Corporation, Rio Tinto Ltd, Singapore Telecom, Telecom Corp NZ, AXA Asia Pacific (formerly National Mutual Life Association of Australasia Limited), Lion Nathan Ltd, and so on. The ownership status of Australia's biggest company, News Corporation, depends on whether or not its Chairman and Chief Executive, Mr Rupert Murdoch is regarded as a US citizen for these purposes. He owned and/or controlled 33. 5 per cent of News Corporation at 30 June 2003, according to the latest News Corp annual report.

Another other important factor is whether or not the present screening by the FIRB is effective or not. According to the latest FIRB annual report, in 2002–03 there were 361 foreign investment proposals by US investors that were approved. The total value of the investment was $30 460 million, or an average of $84 million per investment. Proposals from the US are only 7 per cent of all proposals but represent 33 per cent by value of the proposals. Less is known about the proposals that were rejected or accepted subject to conditions. However we know that all of the rejected proposals related to real estate. However, there were 44 proposals outside the real estate sector that were approved subject to conditions and the main type of condition was environmental. The annual report mentions that 'the low rejection rate reflects the consultative approach taken in the administration of foreign investment policy.' What this means is that there tends to be an informal discussion of the proposal that indicates its likely rejection or approval and those likely to be rejected never make it to a formal application. In addition, problematic proposals can be modified before formal application. Of course, no informal screening would take place without the requirement for approval.

At this point it is useful to canvass some of the analytical arguments surrounding foreign investment. In the case of goods and services the arguments in favour of free trade are well known and tend to be widely accepted, at least in principle. While there are qualifications and conditions under which the arguments are valid, the case has been strongly debated for many years. The case for free foreign investment or free capital movements generally does not have the same tradition and, at best, is an argument by analogy with that for goods and services. Indeed, following the Asian currency crisis of the late 1990s, there is now a strong recognition that free capital movements may be dangerous unless host countries have sufficient institutional and policy strengths.

The term 'foreign investment' includes a continuum of transactions from short-term speculative capital investments of the type that were implicated in the Asian crisis through direct investment by foreign interests that contributes to the Australian capital stock. Examples of the latter would be a foreign-owned car manufacturer tooling up to produce a new model or a foreign-owned mining company developing a mineral deposit.

A more problematic example of direct foreign investment is the case of a foreign takeover of an Australian company. Such a takeover could be argued to involve benefits for the company concerned. Its operations may be improved by better access to management, technology or overseas markets. Indeed, it could be argued that there would be no incentive for any takeover unless the acquiring management thinks it could earn additional profit by utilising the assets of the target company better than the incumbent management. In principle we can think of a market in corporate ownership and control and, subject to certain conditions there will be a competitive equilibrium in which ownership and control will go to those who are in the best position to most effectively manage the corporate assets. However, this is complicated in the real world because generally the businesses involved are large players with some influence in their market. The company initiating the takeover may well be motivated by a desire to better manage the assets of the target company. However, there may also be an aim to dominate the market at the expense of customers, suppliers or some other group. If the parties to the takeover are in the same country then at least the winners and losers will offset each other. However, when the winners and losers are in different countries then one country can be said to gain at the other's expense. In order to really determine whether or not there are merits in a takeover some knowledge of the economic environment is required, including some idea of the incentives facing the actors involved.

Case study

A case study of a foreign takeover was provided by the recent attempt by Shell to mount a hostile takeover against Woodside Petroleum Ltd. This attempted takeover was rejected on national interest grounds and it is important to consider what might have been the result had the Government's discretion been removed as a result of a treaty arrangement.

Woodside is a large Australian resources company, exceeded in value only by BHP Billiton Ltd and Rio Tinto Ltd. Woodside has major interests in the North West Shelf and other offshore petroleum and gas interests. Ultimately the Treasurer, Peter Costello, rejected the Shell bid on national interest grounds, basically on concerns that Shell would be motivated to operate Woodside as part of its global strategy rather than in the interests of the Australian business. In rejecting the bid Mr Costello said:

> It is in the national interest for the operator of this project to develop the resource to its maximum and for sales from the NWS [North West Shelf] to be promoted in preference to competing sales from projects in other parts of the world. Whilst there have been positive discussions with Shell on steps to secure the independence of the operator and marketing functions I have not been able to see that enduring conditions which are fully

> enforceable could be put in place in advance, as such conditions would require action after the approval and require the consent of joint venturers which cannot be guaranteed.

Shell has expressed indignation over the suggestion that it might operate in a manner inconsistent with Australia's interests. However, it is highly unlikely that Shell's interests and those of Australia will always be identical. Shell is in the textbook position of a multi-plant producer:

- with considerable market power
- aiming to maximise returns to shareholders (via the maximising of its own profits), and
- in a position to bring capacity on stream so as to fit in with its profit maximising objectives.

None of this should be taken as singling out Shell in particular. It has to be said that an Australian based multinational may also act against the Australian national interest. If Woodside had Shell's international portfolio of assets, we would have to admit that it would be tempted to act exactly the same as Shell in similar circumstances. It is not the character or identity of Shell that is at question but the incentive structure facing any powerful multi-plant company.