# Analysis of Leaked TPPA Paper for Ministers' Guidance on SOEs

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The leaked paper prepared for ministers on State-owned Enterprises (SOEs) in the Trans-Pacific Partnership Agreement (TPPA or TPP), dated 7–10 December 2013, was prepared for a meeting of ministers from the 12 countries in Singapore.

The TPPA will have a section on SOEs in the Competition chapter. The proposed rules, pushed by the US, go beyond anything in the World Trade Organization (WTO) and Free Trade Agreements (FTAs), including US FTAs.

The SOE text has been totally US-driven. For several years, negotiators reportedly sat around the table asking the US to explain the issues. It was only when Australia offered an alternative approach that the standoff was broken. Clearly, some governments were still reluctant at the time of this paper in late 2013, as it states "a majority of TPP countries" support the additional "disciplines" – meaning handcuffs – on governments.

This paper provides an overview of the obligations and points of conflict, but it is not the draft text. That means much of this analysis is speculative and often takes the form of questions.

## The main obligations

The first section of the leaked paper sets out the main restrictions on how governments are allowed to support their SOEs and what the SOEs are allowed, and not allowed, to do.

It sets out a number of obligations.

1. SOEs and monopolies have to act on the basis of commercial considerations. "Commercial considerations" is a vague term that could have far-reaching consequences. The converse – non-commercial considerations – seems to reframe the public good role of public entities as a negative trait that governments must abandon.

That is intrinsically problematic. SOEs are almost always stateowned because they have functions other than those that are merely commercial, such as guaranteed access to important services, or because social, cultural, development and commercial functions are inextricably intertwined. Many SOEs at central, regional and local government levels provide basic services that have a public dimension, even when they have been converted into a corporate form. What does this mean for them?

The scope of "commercial considerations" raises further questions. Governments may opt for cost recovery, rather than a profit, where a public or infrastructure service is involved. Or an SOE engaged in public broadcasting, railways, or research may have hybrid roles, some being commercial and some not. Would the entire enterprise have to act on the basis of "commercial considerations"?

Even where SOEs are profit-oriented, a government may elect not to extract full commercial profits, and choose to reinvest in the enterprise to strengthen the asset base or the quality of the services in ways that private investors would rarely do. The pricing of goods or services may reflect considerations other than a market price based on supply and demand. This obligation would seem to prevent SOEs from behaving in that way.

Presumably the obligation applies to governments as well as SOEs, and would prevent a government from requiring or facilitating SOEs to act on non-commercial considerations. Depending on the definitions, this could severely fetter governments seeking to pursue mixed objectives through SOEs that are subjected to the chapter. Are there any effective protections for public good aspects of SOE activities, and how are they defined? Terms such as "legitimate public policy objectives" or pursuant to a "government mandate" can be full of fishhooks.

**2. SOEs and monopolies cannot discriminate when buying and selling goods and services** by favouring domestic firms, including other government entities and SOEs.

Many SOEs spend their money in ways that support local businesses for a range of reasons: economic development, employment, circulation of state funding, or ensuring local productive capacity is maintained. Those objectives can be especially important for local government enterprises.

Many SOEs also have special arrangements with other state-owned enterprises, buying goods and services within government for fiscal, security and capacity reasons. This obligation seems to prevent SOEs performing those functions. This could be devastating for a country like Vietnam, whose economic infrastructure centres around SOEs.

As discussed below, SOEs are also subject to the procedural and substantive rules on procurement and local content requirements in the TPPA's government procurement and investment chapters.

**3.** Ensuring SOEs comply with the TPPA when exercising delegated powers. That means SOEs and monopolies must comply with all the other chapters of the TPPA when they exercise a delegated authority. There are legal questions about whether a state's obligations automatically apply to SOEs, so the US will have insisted this is spelt out.

As a result, SOEs would need to become experts in the entire TPPA, including the chapters on intellectual property, government procurement, cross-border services, investment, transparency and regulatory coherence, among many others.

New constraints would apply, for example, to regulatory decisions that involve licensing or setting technical standards for environment, transport, broadcasting or utilities, as SOEs would have to comply with rules on regulating services. The procedures and criteria that govern regulatory decisions under the regulatory coherence chapter, and the rights of commercial interests under the transparency chapter to engage in decisions by SOEs that affect them, would also apply.

The application of investor-state dispute settlement to SOEs is discussed below.

- **4. Courts' jurisdiction over activities of SOEs.** It is not clear exactly what the mischief is that this is meant to solve. Presumably, some countries exempt their SOEs from certain legal obligations and judicial review.
- **5.** Impartial regulation of commercial SOEs and private competitors. It is common for SOEs to have different regulatory regimes from private entities because they are integrated into government systems and perform public interest roles. As a result, they may be subject to specific legislation, regulations or a charter that sets out those roles and responsibilities. They may also have preferential licensing entitlements, tax arrangements, reporting obligations, planning approvals, and special oversight and reporting arrangements. All these would become problematic.

"Impartial" probably also means that regulatory agencies or licensing authorities that are currently connected to the SOEs must be separated. However, the term 'impartial' may also apply to the criteria that are used for regulatory decisions. Regulators may be prevented from giving additional weighting to cultural or social

objectives that are considered integral to the service provided by the SOE in contrast to a private, especially foreign, competitor.

This requirement for a "level playing field" in regulation ignores the reality that SOEs and private firms are driven by different imperatives and obligations. It could make it extremely hard if not impossible for SOEs to continue to comply with their public service obligations, unless very effective protections are written into the chapter.

There is an additional trap that once SOEs and private firms are "competitively neutral" the advocates of privatisation will say there is no justification for retaining state ownership because the private sector can bring efficiency gains, choice and competition to the provision of the public service.

The obligation would also prevent governments from reinstating or creating a new regime for public service corporations that are supported by regulatory frameworks that differentiate between public and private sector roles.

- **7. Transparency** is a fashionable buzzword for ensuring that commercial interests, especially (but not only) foreign firms, are guaranteed increased opportunities to exercise leverage over a government's domestic decisions. The precise meaning is not spelt out in this paper. Judging from transparency provisions in other chapters it is likely to require extensive and onerous disclosure by both governments and SOEs of information relating to compliance with the TPPA's rules on SOEs. It might also provide opportunities for foreign firms to participate in the monitoring and review procedures established under the Competition chapter, which would place SOEs under even more pressure.
- **8. Monitoring and review of implementation.** One of the themes of the TPPA is the imposition of rules and processes on *how* governments make decisions, requiring governments to explain themselves and provide information to other states. This can become a form of harassment, and have a chilling effect on governments.

The combination of transparency, monitoring and review can also seriously disadvantage SOEs commercially. The Singapore-US FTA imposed requirements on Singapore, including the sovereign wealth fund Temasek, which did not apply to its private sector competitors and the investments of Temasek's joint venture partners were exposed by association. Such obligations could act as a deterrent for investors to enter arrangements with SOEs. The problems would be compounded if the rules also applied to investments of sovereign wealth funds, as well as the funds themselves.

## Areas of disagreement among the TPPA parties

The leaked paper identified four areas as problems that ministers needed to discuss. These cut to the core of the rules, and suggest that many governments were nervous about the practical consequences of the SOE provisions.

## 1. Government support for SOEs

It looks like SOEs are not allowed to get government support or non-commercial assistance – such as capital injections, subsidies, grants, cheaper access to finance, government guarantees and access to land, premises or facilities on preferential terms – if that causes "adverse effects" to another TPPA country. That kind of support is often essential for SOEs that provide public functions that are not profitable or are even loss-making.

The rule is extremely tricky for several reasons.

One reason is its scope. The leaked paper suggests the rules limit government support that "affects the interests of another TPP country". 'Affect' is an incredibly broad term. It can be direct or indirect, and the intention behind the support is not relevant. That support merely has to affect "the interests" of another TPPA country.

If that reflects the actual wording in the text it suggests that a postal service, public telecommunications provider or state-owned bank that receives financial support from the government to deliver services into poor areas for social reasons could be challenged by a courier firm, satellite operator or internet bank from another country that says the support is adversely affecting it and hence its country's interests.

A further problem is that the rule preventing government support for SOEs applies to effects on "trade in services". The recognised ways of 'trading' in services include internet providers of a service from offshore, such as broadcasting or satellite tracking of shipping; cross-border transport operations such as airlines and maritime transport; foreign investments in activities such as mining, insurance or electricity; and visiting providers, such as management consultants or researchers. It is not hard to think of examples where subsidies, grants, government guarantees, or cheap access to capital might be considered to have an adverse effect on their operations, and hence their home country's interests.

The paper also suggests that "anti-competitive practices" that allegedly have an adverse effect on a foreign investment could be targeted. That is a common complaint when a state enterprise

performs a number of functions and is seen to cross-subsidise from a state-supported monopoly function to another where it competes with the private sector. This does not have to involve financial subsidies. It could be sharing of facilities, IT networks, transportation and distribution systems, advertising and marketing, or management services. Post and courier is a classic case. Public broadcasting, where it is run as an SOE, would be another. So would public railways where there may be subsidised public service functions and commercial freight operations.

Another problem is technical, but really important. It looks like the text borrows the "adverse effects" test from the goods agreement in the WTO (GATT), which involves complex calculations that are always contested. Here, it looks like the TPPA negotiators want to apply it to services as well, which would be technically unworkable.

The more uncertain these rules are, the greater the risk of a chilling effect as governments and SOEs try to make sure they stay well inside the rules. Governments will know that they face challenges in the proposed "monitoring and review" process and ultimately a costly dispute. That is a really big problem for countries that have a large number of SOEs, or SOEs in particularly sensitive sectors.

## 2. Exceptions and other protections

Given the novelty of the SOE section of the TPPA, and the uncertainty about what it will mean, it is hardly surprising that governments seem to be casting around for ways to protect their most important SOEs.

The paper refers to flexibilities "necessary" to provide "appropriate" policy space. These are terms of art used to limit what governments are allowed to do, and reference to them suggests that policy space will be tightly circumscribed. Again, without the exact text it is impossible to say how limited that will be.

There were early reports that the original US proposal protected specific activities and entities that were important for the US – the car plants, banks and insurers it took over after the global financial crisis, Freddie Mac and Fannie Mae, the export/import agency, and sub-federal jurisdiction.

Other countries have their own concerns, from the massive mining and energy operations in Brunei, Chile, Mexico and Peru, to sovereign wealth funds and their subsidiaries in Singapore and Malaysia, and the entire economic infrastructure of SOEs of many different sizes and sectors in Vietnam. Canada still has some SOEs with public service responsibilities and particular sensitivities around culture. Even highly privatised countries such as Australia and New

Zealand have residual SOEs that are politically sensitive, and opposition parties in New Zealand have proposed the creation of new SOEs in areas such as disaster insurance.

The leaked paper refers to a number of possible approaches, but suggests they might not apply to all of the rules affecting SOEs.

One option is to have "general policy exceptions". This could mean the general exception provision in the agreement would apply to the SOE rules. Or it could mean across-the-board rules for SOEs in areas such as health, culture, environmental services, or pensions. The problem with exceptions is that they are defences that have to be pleaded and justified in a dispute.

A second option is "scope exclusions". Presumably, they are the kind of carve-outs that the US originally proposed. They could also apply to pension and social security funds that are run by SOEs. Canada will doubtless try for a cultural carve-out. "Scope" might also mean a threshold of turnover or asset value of an SOE applies, below which some or all the rules do not apply. Alternatively, there might be a phase-in period before a country or specific SOEs have to comply.

A third possibility is country-specific flexibility. Presumably, that would involve a 'negative list' where a party states what is not covered by some or all the rules. Often governments have to specify existing entities or laws that will be exempted, rather than generic activities or sectors. Negative lists are likely to raise major problems of future-proofing, because they would probably only allow a country to list existing SOEs. Those lists are always negotiated, which makes it very difficult for countries to maintain their optimal protection when other countries, especially the US, are determined to minimise any exceptions.

# Defining SOEs and levels of government

There are no clues in the paper as to how SOEs are defined. Does an SOE have to be wholly government-owned, or is a partially privatised SOE also covered? Would the government have to be a majority owner? What would the private co-owners think of having to comply with rules that would not apply if it were a private company?

How would "exercising control" be defined? Is it determined by whether the government can appoint the directors (and if so, how many), whether there are political representatives on the board, or what influence political shareholders can exercise over decisions? Would it include a golden share that enables the government to exercise key directions over various decisions and to determine the

dividend, or reinvesting the profits back into the business, which a private competitor whose shareholders expect dividends could not do?

Sub-central government also appears to have been a fraught issue. Countries like Singapore, Chile and New Zealand that have a centralised system of governance would be incensed that the vast sub-federal jurisdictions of the US, Canada and Australia might be exempted. The suggestion of a "built-in" agenda on this issue is code for not making decisions now and revisiting it in several years' time. Experience in the WTO suggests that this can be stretched out forever.

## Dispute settlement

The US clearly wants the SOE section of the TPPA to be subject to the full state-state dispute settlement process. That would mean a decision that an SOE had breached the rules could be enforced, if necessary, through "cross-retaliation" – withdrawal of benefits in a different part of the TPPA, such as raising tariffs on exports of the losing country.

Proposals from some countries for an additional process of dialogue and review are probably meant to pre-empt a full dispute, but they might simply extend the pain – a choice between a slow death or a quick assassination.

"Additional dispute settlement elements" is probably code for an additional requirement to provide information to the complaining TPPA country. In theory that might forestall a potential dispute, but it might also provide more ammunition to support a legal challenge.

While the paper refers to state-state disputes, there is also an added potential exposure to investor-to-state dispute settlement. The leaked paper makes it clear that SOEs would be required to comply with all the other chapters of the TPPA when exercising a delegated authority. That includes the investment chapter, and means their activities might be challenged as breaches of the investment rules, including non-discrimination (national treatment), direct and indirect expropriation, and "fair and equitable" treatment.

The controversial investor right to "fair and equitable treatment" is especially problematic because the SOE section appears to have special obligations in relation to "covered investments", especially relating to competition. While a foreign investor cannot directly enforce the SOE chapter through ISDS in the investment chapter, it could claim that it has a legitimate expectation as a result of the SOE section than certain things would happen. If need be they would doubtless be able to point to additional actions or omissions,

or both, of the government or SOE that would add to the grievance, so they were not relying solely on the breach of the SOE chapter to ground their claim.

## Key questions arising from this paper:

What protections are there for public services and public good functions of SOEs, how are they defined, and do they apply to all the rules?

Can governments define which of their SOEs are subject to these rules, or do the other parties all have to agree?

Are all countries treated the same, or will these handcuffs have a much greater effect on countries that have a lot of SOEs?

What does this mean for countries whose economy, jobs and local businesses rely on their SOEs, especially a developing country like Vietnam?

Will the rules only apply to SOEs at central government level, and if so, does that impose disproportionate restrictions on countries that have centralised governments as opposed to those with sub-federal systems of government?

What happens if a state enterprise has a hybrid of commercial and social or public good functions, or the market model has failed and the government wants to restore that function and subsidise the SOE to provide it?

How can universal service obligations, such as postal services or telecoms, be protected if SOEs receive special payments to provide them?

Would payments for a universal service obligation be an anticompetitive subsidy if the SOE also carried out other activities that compete with the private sector?

Can a new SOE be established to meet a social or market failure if it needs initial capitalisation or other support?

If an SOE is in trouble can a government provide an injection of funds or must it let the SOE fail?

Is the SOE section of the TPPA a backdoor to privatisation by stripping away the social and subsidised aspects of SOEs, so there is no reason why they cannot just as easily be run by the private sector?

If investments from TPPA countries have to be given the same treatment as SOEs can they use investor-state dispute settlement to challenge what foreign investors consider to be discrimination, or claim they are unfairly treated because their expectations have not been met?

How are monopolies over natural resources or infrastructure affected?

Do the rules that apply to monopolies affect existing as well as future monopolies?

What protections are there against abuse or harassment of governments or individual SOEs under the proposed monitoring and review process?

Could one government tie up the resources of another country's SOEs by constant demands for information as part of monitoring and review processes, and put those SOEs at a competitive disadvantage because private competitors do not have to disclose that information?

If this is a completely new set of rules, does every government really know how they will work, and are they confident about how a dispute body would rule on a dispute?

Because the 'transparency' provisions in other chapters, including the Transparency and Regulatory Coherence chapters, also apply to SOEs could competitors from another country use those provisions to keep demanding information, explanations and reviews on regulatory decisions that involve SOEs?