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Canada Gives Green Light to CNOOC and Petronas Deals, But Red Light to Future SOE Takeovers in Oil Sands

By Sandy Walker

On Friday, December 7th, the Canadian Government approved two controversial takeovers of Canadian companies under the *Investment Canada Act*, Canada's foreign investment review legislation: the acquisition of oil and gas company Nexen by Chinese state-owned enterprise (SOE), CNOOC, and the acquisition of natural gas producer Progress Energy by Malaysian SOE, Petronas.

The Investment Canada reviews of these two investments have required a delicate balancing act for Prime Minister Harper, particularly for the CNOOC transaction. On the one hand, the Government did not wish to undermine the enormous progress in the Canada-China relationship that has been made over the past three years (since the Prime Minister's first trip to China) but on the other hand, vociferous opposition to the deal within the governing Conservative Party and expressions of concerns from various stakeholders within Canada had to be addressed.

Thus, while Canada has given the green light to CNOOC and Petronas, it also announced a new and more stringent policy framework for the review of SOE investments in Canada. The new policy reflects the Government's limited tolerance for significant foreign government ownership in the Canadian economy and in the oil sands in particular:

- Further acquisitions of control of a Canadian oil sands business will be prohibited except on an "exceptional" basis.

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- The SOE guidelines have been revised to intensify scrutiny of SOE investments, especially in sectors where SOE influence in a particular industry is deemed significant. SOEs will also be expected to be transparent, constrain state influence and operate according to free market principles.

- The definition of SOEs has been broadened to include companies that are "influenced" by foreign governments not just those that are controlled or owned by foreign governments.

- Unlike for other foreign investments, the threshold at which Investment Canada review for SOE investments will not increase to $1 billion over the next four years but will remain at the current $330 million in book value of assets.

- The Government will propose amendments to the *Investment Canada Act* to give the Minister of Industry the power to extend the time available "in exceptional circumstances" to conduct national security reviews of proposed foreign investments (whether or not by SOEs) in order to ensure "careful and thorough reviews".

Red Light for SOE Acquisitions of Control in Oil Sands, Amber Light for Other SOE Investments

The Government's statement on investment by foreign SOEs states that SOEs will only be allowed to acquire control of oil sands businesses "on an exceptional basis". Nevertheless, the Government has been careful to clarify that SOE investments to acquire minority interests, including joint ventures, are "welcome".

In addition, there is no specific prohibition on takeovers (i.e., acquisitions of control) of Canadian oil and gas companies that are not engaged in the oil sands. Nevertheless, the Minister of Industry will "carefully monitor SOE transactions through the Canadian economy" and in particular, "the degree of control or influence an SOE would likely exert on the industry in which the Canadian business operates". This implies that the Government may in the future step in to restrict SOE investment in other sectors where the level of SOE investment becomes unacceptable.

Factors to be Considered in SOE Investment Review

The 2007 guidelines on state-owned investments focused on corporate governance and commercial orientation as the central criteria beyond the traditional (economically focused) factors necessary to show that an investment would be of "net benefit to Canada". The Government has added a number of new or revised factors to the revised guidelines:

- SOEs must address in their commitments to the Canadian Government "the inherent characteristics of SOEs, specifically that they are susceptible to state influence". While the 2007 guidelines stated that the Government would examine how and the extent to which the SOE was controlled by a state, the new requirement that the SOE investor address state influence in their plans and undertakings signals the Government's determination to scrutinize individual SOEs more closely. Given the heterogeneity of SOEs, the burden of this requirement could vary significantly between SOEs from different countries and within different sectors.

- The requirement that SOEs demonstrate their strong commitment to "transparent and commercial operations" is also new text, although really a further elaboration of existing requirements of governance and commercial orientation.

- While the 2007 guidelines stated that the Government would consider whether the SOE adhered to Canadian laws and practices, the new guidelines have added "including adherence to free market principles". It will

be interesting to see how the Government intends to measure whether free market principles govern. This could potentially involve a very burdensome investigation into the company or on the other hand, might be implemented as a fairly cursory review. Moreover, there is a wide range of free market principles that exist and arguably SOEs are being held to a test that even some Canadian businesses would not meet (e.g., the dairy business).

- SOEs must now also address the impact of their investments on the productivity and industrial efficiency of the Canadian business. The emphasis on this concern in the new guidelines responds to concerns of commentators who argued that SOEs were inherently less efficient than private companies and therefore takeovers by such entities may not be beneficial to Canada[1].

Lower Threshold for Review of SOE Transactions

SOE investors will face Investment Canada review for smaller transactions than other foreign investors. In particular, SOE investments will not benefit from the planned increase in the monetary threshold at which an investment is reviewable under the *Investment Canada Act*. This threshold was amended in 2009 to increase to $1 billion in "enterprise value" of the target Canadian business within four years from the time an implementing regulation is passed. Instead, SOE investments in target Canadian businesses will be reviewable when the business has a book value of assets equal to or exceeding $330 million. Generally, this means that more SOE investments will be subject to review compared to investments by private sector foreign investors, although enterprise value for a given company may be significantly higher than its book value of assets.

Expanded definition of SOE

The Government has expanded the definition of SOEs to include not only entities that are owned or controlled by a foreign government but entities that "are influenced directly or indirectly by a foreign government". This addition could potentially result in private companies in countries such as China being considered state-owned and will likely generate uncertainty as to what influences are considered relevant and sufficient. For example, significant board membership by the foreign government would clearly result in government influence but what percentage of board seats would be sufficient to constitute influence? Will the presence of government party appointees (e.g., Chinese Communist Party officials) in senior management of a private sector company convert it into an SOE?

As a result, there may, in certain instances, be significant uncertainty about whether the lower review thresholds applicable to SOEs will apply and therefore whether a review is required. Given that the Government does not have any obligation under the *Investment Canada Act* to provide written opinions on such matters (although it may choose to do so), this expansion of the SOE definition may generate substantial concern among foreign investors who are not state-controlled and could have a chilling effect on investment in Canada.

Conclusion

What appears to underlie the Government's new policy are concerns about foreign "nationalization" of the Canadian economy and about enhancing Canada's leverage against foreign SOEs wishing to invest in Canada.

In his public statement, Prime Minister Harper noted: "To be blunt, Canadians have not spent years reducing ownership of sectors of the economy by our own government only to see

[1] See, for example, Jack Mintz, "Jack Mintz: Limit State Takeovers", at http://opinion.financialpost.com/2012/07/24/jack-mintz-limit-statetakeovers/

them bought and controlled by foreign governments instead"[2]. His allusion is to the federal and provincial crown corporations that have been privatized over the past few decades, including Canadian National Railway, Petro-Canada and Potash Corp. of Saskatchewan (whose takeover by BHP Billiton was rejected by the Canadian Government two years ago).

As a result of its more stringent policy on SOEs, the Canadian Government reportedly anticipates that it will have greater ability to negotiate access to the Chinese market for Canadian firms (although it is not anticipated that such leverage would be exerted within the context of a review of a particular transaction). The Government reportedly did not expect a positive initial response from China on the new prohibition on SOE takeovers in the oil sands[3]. Interestingly, Chinese media coverage to this point has focused on the approval of the CNOOC/Nexen deal and its positive implications for Canada-China bilateral economic relations. Given China's own restrictions on foreign investment in its energy sector, it may be difficult for the Chinese government to publicly show its displeasure about the new policy – at least until a new proposed investment that might be rejected under the new policy.

Whether Canada's new policy on SOEs will significantly chill SOE investments in Canada and in the oil sands in particular remains to be seen. The recent trend has been for SOEs to move towards acquisitions of control rather than joint ventures or minority investments in the resources sector; outside of the oil sands, they can continue to do so – at least for now. Within the oil sands, other creative means of securing the supply of resources are available. For example, SOEs contemplating a minority stake in new oil sands projects could negotiate so-called "off-take agreements" giving them access to greater than 50% of the bitumen produced. Given the economic complementarities between Canada and countries (such as China) that are home to many SOEs[4], it can only be expected that such alternatives will be pursued with vigour in the future.

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Links to the Government's statements and guidelines on Investment Canada review of foreign SOE transactions are available through http://news.gc.ca/web/article-eng.do?nid=711489.

2 See article by Shawn McCarthy and Steven Chase, "Ottawa builds fence around oil sands", The Globe and Mail, Saturday, December 8, 2012, at A3.

3 Indeed, it is not clear that the Alberta Government is pleased about the new rules.

4 These complementarities were identified by the Chinese and Canadian Governments as recently as August 2012 in the so-called "Canada-China Economic Complementarities Study" available at http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/china-chine/study-comp-etude.aspx?view=d.