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I. INTRODUCTION

U.S. companies and industries are built on capitalism and free markets, all of which enjoyed undeniable and unprecedented global success in the 20th century. However, that success is now potentially threatened by the rising use of state power in global commerce. Indeed, "[t]he invisible hand of the market is giving way to the visible, and often authoritarian, hand of state capitalism"[2] – a disturbing trend with significant economic and security implications for U.S. companies who compete with China for business, whether in China, the United States or elsewhere in the world.

Particularly troublesome for free-market economies is the growing use of state-owned and state-supported enterprises, both within a country's borders and in global markets, including in the United States. China, in particular, has created massive state-owned and -controlled national champions that are designed to be competitive on the international stage. These state-owned enterprises ("SOEs") are instrumentalities of the state, subject to varying degrees of direction and control by the Chinese government, and are often protected from competition in their own market. They are motivated not only by economic concerns, but also by government objectives, including technology transfer, access to raw materials, job creation and geopolitical influence.

While the involvement of SOEs in the Chinese market is harmful enough, the growth of Chinese SOE investment abroad represents a new and growing threat to fair competition and the ability of U.S. producers to compete here and around the globe. Subsidized and otherwise advantaged by the Chinese government, these SOEs often do not operate based on market principles and therefore can introduce anti-competitive behavior and other market distortions where they invest. In addition, Chinese SOE investment and operations abroad force U.S. companies to compete directly against the Chinese government in our home and global markets, creating significant imbalances that harm U.S. workers and private companies competing in these markets.

II. THE RESURGENCE OF STATE CAPITALISM IN CHINA

While Chinese SOEs are not a new phenomenon, the degree of state involvement in economic activity is growing in certain sectors, as the Chinese government is increasingly pursuing ownership, control and direction of key industries and companies. The Chinese government continues to control the "commanding heights" of the economy, including ownership of major

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[2] Adrian Wooldridge, *The visible hand*, The Economist (Jan. 21, 2012) ("*The visible hand*") at 5.

sectors such as banking, insurance, raw materials and steel. China's strategic plan for these and other "pillar" industries is to create massive state-owned and -controlled national champions that are capable of competing on the international stage. Pursuant to government-issued industrial policies, these SOEs are now expanding overseas with the full support of the Chinese government, to pursue government objectives.

A. Growing State Ownership and Control in China

After a brief period of economic liberalization in the 1980s and 1990s, the Chinese government has reasserted its power over its SOEs and various sectors of the economy. For example, in 2003, the Chinese government established the State-owned Assets Supervision and Administration Commission of the State Council ("SASAC") to exercise ownership rights over China's largest SOEs. SASAC enables the Chinese government to exercise considerable control over the commercial decisions of SOEs, including decisions relating to their strategies, management and investments.[3] China's recently issued 12th Five-Year Plan further demonstrates the government's continued and substantial involvement in the economy, providing for direct government ownership and control over certain key sectors of the economy. The plan explicitly states that one of its goals is to "uphold the basic economic system in which public ownership is the mainstay."[4]

SOEs now constitute 80 percent of the value of the Chinese stock market, and the Chinese government is the biggest shareholder in China's 150 largest companies.[5] Many companies which are not wholly-owned by the government are nonetheless subject to state control. As the Commission has recognized, "[t]he state's influence over China's economy takes many forms and covers a whole spectrum of companies from fully state owned to those that are nonstate but maintain close ties to the government."[6]

B. China's "Going Abroad" Policy and Increasing Chinese SOE Investment in the United States

As the next step in its government-directed industrial strategy, China is accelerating its "Going Abroad" strategy, deploying its massive state-owned national champions overseas to further the government's objectives. First announced by the government in 1999, China's "Going Abroad" strategy is a government-mandated policy intended to strengthen the presence of Chinese companies abroad. The policy is mandated by government industrial plans at both the central and provincial government levels. Many of these policies identify which entities are to go abroad, and call for government subsidies and other support to enable these entities to do so. For example, the *2009 Revitalization Plan* encourages Chinese steel producers to "make exclusive

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3 *See* United States Trade Representative, *2011 Report to Congress on China's WTO Compliance* (Dec. 2011) ("USTR Report on China's WTO Compliance") at 59.

4 Chapter 45 of Title XI in China's Twelfth Five-Year Plan (Reform in Different Areas, Improving Socialism Institution of Market Economy).

5 *The visible hand* at 4. *See also* U.S.-China Economic and Security Review Commission, *2011 Report to Congress* (Nov. 2011) ("Commission's 2011 Report to Congress") at 40 ("there are more than 100,000 smaller companies that are owned or operated by provincial and local governments").

6 Commission's 2011 Report to Congress at 40.

investments or set up joint ventures abroad" and encourages "qualified backbone enterprises . . . to carry out resource exploration, development, technical cooperation and mergers and acquisitions . . . overseas."[7]

China's "Going Abroad" policy has been successful to date. In 2005, Chinese outward foreign direct investment ("FDI") totaled $10.2 billion; in 2011, that figure rose to nearly $73 billion.[8] Overall, Chinese companies have made foreign investments totaling approximately $443.2 billion.[9] Moreover, at least 80 percent of all Chinese outward FDI has been funded by SOEs.[10] The figure is likely much higher, as Chinese government statistics demonstrate that private enterprises accounted for only 0.6 percent of all outward FDI from China in 2009.[11] The energy and power sectors and the metals sector continue to draw the largest investments from China.[12]

The Western Hemisphere is the most popular destination for Chinese investment outside of Asia, but China is only beginning to invest heavily in the United States.[13] Even so, Chinese SOEs have made several large U.S. investments in recent years. For example, in mid-2011, the state-owned Aviation Industry Corporation of China ("AVIC") acquired Minnesota-based Cirrus Industries, Inc., giving the Chinese aerospace company access to Cirrus' technology.[14] This latest acquisition came soon after AVIC's purchase of Continental Motors, an Alabama aircraft manufacturer, in late 2010.[15] Chinese SOEs have also shown interest in the U.S. energy sector, with the Chinese National Offshore Oil Company's purchase of a $2.2 billion stake in 600,000 acres of Texas oil and gas fields[16] and China Investment Corporation's acquisition of a 15

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[7] 2009 Revitalization Plan.

[8] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at Chart 1.

[9] *See* the Heritage Foundation, *China Global Investment Tracker Interactive Map*, available at http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map.

[10] *The visible hand* at 15.

[11] *See* Nargiza Salidjanova, Policy Analyst for Economic and Trade Issues, *Going Out: An Overview of China's Outward Foreign Direct Investment*, USCC Staff Research Report (March 30, 2011) at 6.

[12] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at 3-4.

[13] Derek Scissors, Ph.D., *Chinese Outward Investment: Slower Growth in 2011*, The Heritage Foundation (Jan. 9, 2012) at 3-4. *See also* Keith B. Richburg, *U.S. says it wants investment, but China remains wary*, Washington Post (Feb. 10, 2012).

[14] *See* Norihiko Shirouzu, *China to Buy U.S. Plane Maker*, Wall Street Journal (Mar. 3, 2011), available at http://online.wsj.com/article/SB10001424052748704728004576176243061806326.html; *Dewey & LeBoeuf Advises China Aviation Industry General Aircraft on Acquisition and Regulatory Approval of US Aviation Business* (July 4, 2011), available at http://www.deweyleboeuf.com/en/Firm/MediaCenter/PressReleases/2011/07/DeweyLeBoeufAdvisesChinaAviation.

[15] *Teledyne Technologies Agrees to Sell Teledyne Continental Motors to AVIC International* (Dec. 14, 2010), available at http://www.teledyne.com/news/tdy_12142010.asp.

[16] *See* Monica Hatcher, *China stakes claim to S. Texas oil, gas*, www.mysanantonio.com (Oct. 12, 2010) http://www.mysanantonio.com/business/local/article/China-stakes-claim-to-S-Texas-oil-gas-858329.php#ixzz1lpDXKbQs.

percent stake in AES Corporation, a U.S. power generating company.[17] A subsidiary of state-owned China National Petroleum Corporation owns 51 percent of INOVA Geophysical Equipment, a U.S. provider of land geophysical technology, as a result of a joint venture with ION Geophysical.[18]

Finally, China has also begun investing in the U.S. steel industry. In January 2009, Chinese state-owned Tianjin Pipe Group Corp. ("TPCO") announced its plans to invest in the construction of a steel pipe plant near Corpus Christi, Texas, its first U.S. production operation.[19] In 2010, the fourth largest Chinese steel producer, Anshan Iron and Steel, announced plans that it was forming a joint venture with Steel Development Company to build up to 5 new steel plants in the United States.[20] Anshan is 100 percent owned and controlled by the central Chinese government and has received massive government subsidies. A number of Chinese government industrial plans explicitly identify Anshan as a recipient of extensive government support in order to strengthen its international competitiveness and to assist it in establishing operations abroad. In fact, Anshan itself made clear that its U.S. investment was part of the government's "Going Abroad" strategy.[21] While this investment has not moved forward, investments like it would pose serious competitive challenges in the U.S. market.

III. CHINESE SOES POSE COMPETITIVE CHALLENGES IN THE UNITED STATES AND ABROAD

Chinese SOE investment and operations in global markets may result in anti-competitive behavior and other distortions that adversely impact U.S. companies and workers. Many SOEs receive substantial subsidies from the Chinese government, including cash grants, below-market financing and other support, even in the worst economic conditions. As a result, these entities do not need to make a profit and have little incentive to make production, pricing or other business decisions based on market principles, giving them a significant advantage over their private sector competitors. Moreover, China's SOEs often operate at the direction of the government and for the purpose of advancing government aims, rather than in accordance with commercial principles.

The potential adverse economic and security impacts of SOE participation in the marketplace and investment abroad have been well documented. For example, the Organization for Economic Cooperation and Development ("OECD") has released a number of reports detailing

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17 *AES Announces Close of Transaction with China Investment Corporation* (Mar. 15, 2010), available at http://investor.aes.com/phoenix.zhtml?c=76149&p=irol-newsArticle&ID=1402516&highlight=.

18 *See INOVA Geophysical and BGP Execute Successful High Productivity Vibroseis Project in Oman* (Apr. 19, 2011), available at http://www.prnewswire.com/news-releases/inova-geophysical-and-bgp-execute-successful-high-productivity-vibroseis-project-in-oman-120193189.html.

19 *China's TPCO plans build of $1B pipe mill in Texas*, MetalBulletin.com (Jan. 2, 2009). This investment was made possible by massive Chinese government subsidies. *See* Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 9, available at http://www.steelnet.org/new/new_body.html.

20 *See* Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 9-11, available at http://www.steelnet.org/new/new_body.html.

21 *Id*.

the rise of SOE investment abroad and the related anti-competitive effects and market distortions that may result, both in the SOE's home market and in markets around the world. The OECD has concluded that:

> In most instances, SOEs enjoy privileges and immunities that are not available to their privately-owned competitors. These privileges give SOEs a competitive advantage over their rivals. Such advantages are not necessarily based on better performance, superior efficiency, better technology, or superior management skills but are merely government-created and can distort competition in the market.[22]

The various distortions caused by SOE investment and operations in global markets are discussed in further detail below.

A. Chinese Government Subsidies and Other Benefits Provide its SOEs with Unfair and Market-Distorting Competitive Advantages

Chinese SOEs often receive massive subsidies and other benefits from the Chinese government, which bestow an unfair competitive advantage on SOEs in their worldwide operations. As this Commission has documented, such subsidies are prevalent in China, and often at substantial levels.[23] Some of the most significant ways in which the Chinese government benefits its companies and distorts the global marketplace are described below.

- Direct subsidies: The Chinese government provides direct subsidies to its SOEs in the form of cash grants and/or capital infusions.[24] One example is the government's grant of RMB 50.9 billion to SOE Sinopec Corp. to cover the company's losses in 2008.[25]

- Preferential loans and access to finance: China's state policy banks and state-owned commercial banks have traditionally made loans based on political directives, rather than creditworthiness or other market-based factors.[26] Government-owned banks in China frequently make loans to SOEs on preferential terms. As reported by *The Economist*, Chinese SOEs enjoy favorable interest rates on loans from state-owned banks, paying only 1.6 percent interest on such loans, while private companies are charged 4.7 percent

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[22] *Competitive Neutrality in the Presence of State Owned Enterprises*, OECD, DAF/CA/PRIV(2010)1 (Apr. 2, 2010) ("April 2010 OECD Paper on Corporate Neutrality and SOEs").

[23] *See, e.g.*, Commission's 2011 Report to Congress at 40 (China's state-owned and state-controlled companies "receive massive government subsidies and are protected from foreign competition").

[24] *See* Andrew Szamosszegi and Cole Kyle, *An Analysis of State-owned Enterprises and State Capitalism in China*, prepared for the U.S. China Economic and Security Review Commission (Oct. 26, 2011) ("Analysis of Chinese SOEs and State Capitalism") at 20.

[25] Analysis of Chinese SOEs and State Capitalism at 20.

[26] *See* Stephen Lacey, *How China Dominates SolarPower*, The Guardian (Sept. 12, 2011), available at http://www.guardian.co.uk/environment/2011/sep/12/how-china-dominates-solar-power ("The [China Development Bank ('CDB')] was originally set up as a "policy bank," to operate as an arm of the Chinese central government... Now it… reports to China's national cabinet on certain policy issues, [allowing] the Chinese government to get involved in CDB activities and direct loans…").

interest – if they can access credit at all.[27] In fact, approximately 85 percent of China's $1.4 trillion in bank loans went to state-owned companies in 2009.[28] Such concessionary funding is often used to finance an active foreign acquisition strategy for SOEs.[29] Loans by China's policy banks also distort the market in industries not dominated by SOEs. In the solar manufacturing industry, for example, individual Chinese producers have received billions of dollars in loans and loan guarantees.

- Tax reductions and exemptions: Many Chinese SOEs benefit from preferential tax rates and exemptions from both the central and provincial governments in China. "The Chinese government has long used lower tax rates to reward firms for undertaking investments, procuring goods and services, and performing other activities that market incentives alone would not support."[30] U.S. regulatory filings for firms owned by Chinese SOEs demonstrate that "many SOEs and subsidiaries were beneficiaries of preferential tax rates."[31]

- Preferential access to raw materials and other inputs: The Chinese government also supports its SOEs and other domestic manufacturers by ensuring them adequate supplies of low-priced raw materials. These and other inputs are often provided to SOEs at below market prices. In addition, China has imposed various export restrictions on steel-making raw materials and rare earth elements, even though China is the largest source of many of these materials. This causes supply crises for manufacturers around the world, while providing Chinese companies – such as those in the state-dominated steel industry – with an unfair competitive advantage. The World Trade Organization's ("WTO's") Appellate Body recently upheld a dispute settlement panel's finding that China had violated several of its commitments by imposing WTO-inconsistent export restrictions on raw materials, including bauxite, coke and zinc.[32]

- Preferential regulatory treatment: SOEs in China are often not subject to the same costly regulatory regimes as private companies, resulting in lower operating costs than their private competitors. Such preferential treatment includes: exemption from regulatory regimes such as antitrust enforcement, zoning regulations or disclosure regulations;

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[27] *The visible hand* at 15. The World Trade Organization ("WTO") recognized in 2010 that domestic private enterprises in China, as opposed to SOEs, were finding it more difficult to access credit from banks. *See* WTO, Trade Policy Review of China, Report of the Secretariat, WT/TPR/S/230 (Apr. 26, 2010) at 54, available at http://www.wto.org/english/tratop_e/tpr_e/tp330_e.htm.

[28] *The visible hand* at 7.

[29] *See* April 2010 OECD Paper on Corporate Neutrality and SOEs at 7; *The Corporate Governance of SOEs Operating Abroad*, OECD, DAF/CA/PRIV(2009)8 (Oct. 8, 2009) ("Corporate Governance of SOEs Operating Abroad") at 10.

[30] *See* Analysis of Chinese SOEs and State Capitalism at 45.

[31] Analysis of Chinese SOEs and State Capitalism at 45.

[32] *China – Measures Related to the Exportation of Various Raw Materials*, Reports of the Appellate Body, WT/DS394/AB/R, WT/DS395/AB/R, WT/DS398/AB/R (Jan. 30, 2012), available at http://www.wto.org/english/news_e/news12_e/394_395_398abr_e.htm.

preferences in government procurement; and preferential tax treatment, including tax exemptions, reductions or other tax-related concessions.[33]

All of these subsidies and other benefits artificially lower SOEs' costs and enhance their ability to sell at lower prices than their private sector competitors. Thus, the potential anti-competitive repercussions of government subsidies to SOEs include predatory pricing and raising rivals' costs.[34] In addition to lowering profits for private companies and potentially threatening their survival, "[p]redation or raising rivals' cost takes away the ability for [private] competitors to invest in increased research and development and limits their ability to roll out new products and services and processes that increase dynamic gains from innovation."[35] Beyond unfair cost advantages, some unprofitable SOEs, which in a free market would be driven out of business, "may enjoy outright exemptions from bankruptcy rules."[36] The OECD also notes the possibility for "cross-subsidization" of SOEs, which can occur where SOEs "charg[e] excessive revenues in certain 'lucrative' areas in order to be able to fund the public service obligations elsewhere."[37]

A number of additional anti-competitive effects result from the fact that control of an SOE cannot be transferred as easily as in privately-owned firms. These advantages include: some SOEs are not required to pay dividends or any return to shareholders; SOEs will be more inclined to engage in anti-competitive (and rarely profitable) exclusionary pricing strategies without fear of falling stock prices when losses are incurred due to the below-cost pricing; and SOEs' management will have less incentive to operate the enterprise efficiently as it is not subject to the threat of takeovers and is generally impervious to the disciplining effects of capital markets.[38]

Moreover, the asymmetric availability of information and lack of transparency that characterize state-dominated economies like China's can create market distortions. If SOEs have access to government information, including classified intelligence, while their private competitors do not, then these entities trade at what could be an unfair advantage, undermining market confidence.[39]

These anti-competitive effects essentially cause U.S. companies to compete in global markets with foreign governments, and all of their resources and power, rather than with similarly-situated privately-owned foreign companies. The resulting anti-competitive effects are experienced by companies in markets around the globe. Not surprisingly, in many cases,

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[33] *See Competitive Neutrality in the Presence of State Owned Enterprises*, DAF/CA/PRIV(2010)1 (Apr. 2, 2010) at 6-7 and 20.

[34] April 2010 OECD Paper on Corporate Neutrality and SOEs at 6; Corporate Governance of SOEs Operating Abroad at 9-10.

[35] *Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options*, OECD Corporate Governance Working Papers, No. 1 (May 2011) ("May 2011 OECD Paper on Competitive Neutrality and SOEs") at 19.

[36] May 2011 OECD Paper on Competitive Neutrality and SOEs at 6.

[37] May 2011 OECD Paper on Competitive Neutrality and SOEs at 8.

[38] April 2010 OECD Paper on Corporate Neutrality and SOEs at 7-8.

[39] Corporate Governance of SOEs Operating Abroad at 10-11.

Chinese FDI into global markets has pushed out local companies, who are unable to compete with heavily subsidized Chinese SOEs.[40]

B. Case Study of Chinese Subsidies and Resulting Market Distortions: China's Solar Industry

China's renewable energy sector demonstrates the effects of state capitalism in China and Chinese government subsidies at work. Over the past decade, China's solar industry has expanded at a phenomenal rate. In 2008, "China became the largest producer of solar panel cells in the world, shipping … roughly one-third of worldwide total [solar] cell shipments."[41] China remained the world's largest producer of solar cells in 2009 and 2010[42] and captured more than half of the global cell market for the first time in 2010.[43]

This rapid and unprecedented expansion was the direct result of the Chinese government's support for its solar energy industry, including its granting of an extraordinary range and amount of subsidies to the industry. Some companies in China's solar industry are SOEs; many others are effectively state-controlled because of close connections to the government, or because they are dependent on the government for subsidies.[44]

Moreover, Chinese producers of polysilicon – the major input into solar cells – are largely state-owned.[45] In fact, research conducted in China shows that, over the last decade, the Chinese government has created its own state-owned and -controlled polysilicon industry. Now, nearly all of the largest polysilicon producers in China are state-owned or -controlled. In the past,

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[40] *See, e.g.*, Stanley Kwenda, *Zimbabwe: Chinese become unwelcome guests*, TradeMark Southern Africa (Jan. 9, 2012), available at http://www.trademarksa/org/news/zimbabwe-chinese-become-unwelcome-guests.

[41] Dewey & LeBoeuf LLP for the National Foreign Trade Council, *China's Promotion of the Renewable Electric Power Equipment Industry: Hydro, Wind, Solar, Biomass* (Mar. 2010) at 75.

[42] *See Why Solar Prices Will Continue Falling*, Hexun News (Apr. 18, 2011); Keith Bradsher, *China Leading Global Race to Make Clean Energy*, The New York Times (Jan. 30, 2010).

[43] *Asia Doubles Solar Silicon Factories, Pursuing Gain in Slump*, Bloomberg News (July 10, 2011).

[44] For example, CGN Solar Energy Development Co. is a subsidiary of SOE China Guangdong Nuclear Power Group. *See* Ucilia Wang, *China, finally, emerging as big market for solar demand*, www.gigaom.com (Nov. 22, 2011), available at http://gigaom.com/cleantech/china-finally-emerging-as-big-market-for-solar-demand; Marco Lui, *GCL-Poly Energy Enters Into Co-Operative Agreement With CGN Solar*, Bloomberg (Nov. 17, 2011), available at http://www.bloomberg.com/news/2011-11-17/gcl-poly-energy-enters-into-co-operative-agreement-with-cgn-solar.html. China's largest solar power plant developer, CECEP Solar Energy Technology, is an SOE. Sonal Patel, *U.S.-China Solar Trade Dispute Gets Thornier*, POWER (Jan. 1, 2012), http://www.powermag.com/renewables/solar/4280.html.

[45] For example, Yichang CSG Polysilicon Co., Ltd is a subsidiary of the China Southern Power Grid Company Limited ("CSG"), an SOE. *See* Yichang CSG Polysilicon Co., Ltd., *Company Profile*, http://www.csgpolysilicon.com/enwww/about.asp?ID=19; International Rivers, *China Southern Power Grid*, available at http://www.internationalrivers.org/node/3314. The China Investment Corporation ("CIC"), a wholly state-owned company, holds an interest in CGL-Poly Energy Holdings Limited. *See GCL-Poly sells $710 mln shares to China Investment Corp*, Reuters (Nov. 18, 2009), available at http://www.reuters.com/article/2009/11/19/gcl-cic-idUSHKG24700920091119; China Investment Corporation, *Overview*, http://www.china-inv.cn/cicen/about_cic/aboutcic_overview.html.

China procured much of its polysilicon from U.S. producers.[46] However, because of the industry's government ownership and other government support, polysilicon production in China has skyrocketed in the past five years,[47] and U.S. polysilicon exports to China are declining.[48]

China has aggressively pursued a national policy to support its SOEs and other Chinese companies in the solar industry. In 2005, the GOC enacted the *Renewable Energy Law* to "promote the exploitation of renewable energy."[49] The law established a national policy to encourage the use of solar and other renewable energy sources, and it "encourages economic entities of various ownerships to participate in the exploitation of renewable energy and protects the lawful rights and interests of the exploiters of renewable energy."[50] A number of other measures have been passed to strengthen government support for China's solar industry, many of which explicitly call for subsidies.[51]

The Chinese government has consistently furthered this national policy through the provision of various subsidies to its solar industry. From only January 2010 through September 2011, preferential loans and credit provided by state-owned Chinese banks to Chinese solar producers totaled nearly $41 billion[52]– an unprecedented amount, even for China. The central, provincial and local Chinese governments also provide a variety of tax exemptions, reductions and credits that directly benefit China's solar producers.[53] In addition, the Government of China subsidizes

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46 *See, e.g.*, Greentech Media, *U.S. Solar Energy Trade Assessment 2011* (Aug. 2011) at 49.

47 In 2009 alone, Chinese polysilicon production rose 300 percent from 2008 levels. *See* Coco Liu, *China to Restrict Polysilicon Production*, greentechmedia.com (Mar. 16, 2010), available at http://www.greentechmedia.com/articles/read/china-to-restrict-polysilicon-production/; Zachary Tracer and Joshua Fellman, GCL-Poly Plans to Boost Polysilicon Capacity Amid Oversupply, Bloomberg (Nov. 14, 2011), available at http://www.bloomberg.com/news/2011-11-14/gcl-poly-plans-to-boost-polysilicon-capacity-amid-oversupply.html.

48 From 2010 to 2011, U.S. polysilicon exports to China decreased by nearly 60 percent. 2010 export data obtained from Greentech Media, *U.S. Solar Energy Trade Assessment 2011* (Aug. 2011); 2011 data based on official U.S. import/export statistics as reported by the U.S. International Trade Commission.

49 *Renewable Energy Law of the People's Republic of China* (Feb. 28, 2005) at Art. 1.

50 *Renewable Energy Law of the People's Republic of China* (Feb. 28, 2005) at Art. 4.

51 For example, the June 2006 *National Medium- and Long-Term Program for Science and Technology Development* (2006 – 2020) sets forth goals for the renewable energy sector, with emphasis on developing "high-performance and low-cost solar voltaic cells" and establishing financial and tax policies to encourage research and development in the priority sectors. In September 2007, the National Development and Reform Commission ("NDRC") released the *Medium and Long-Term Development Plan for Renewable Energy in China* to "speed up the development and deployment of hydropower, wind power, solar energy, and biomass energy; . . . {and} increase market competitiveness." The plan directs local authorities to "allocate the necessary funds to support renewable energy development."

52 Mercom Capital Group, *Loans and Credit Agreements involving Chinese Banks to Chinese Solar Companies since Jan 2010* (Sept. 25, 2011) available at http://mercomcapital.com/loans-and-credit-agreements-involving-chinese-banks-to-chinese-solar-companies-since-jan-2010.

53 For example, the government of China provides preferential tax benefits to enterprises with foreign investment that are recognized as "high" or "new" technology enterprises or are established in "high" or "new" technology industrial development zones. China has identified new-energy and efficient energy-saving technology as "high and new" technologies. *See, e.g.*, LDK Solar Co., Ltd. 2010 Annual Report and Notice of General Meeting

export-oriented renewable energy producers. For example, to support the export of products listed in China's *Catalogue of Chinese High-Tech Products for Export*, which includes solar energy products, the Export-Import Bank of China provides export-contingent loans at preferential rates. In 2010 alone, new medium- and long-term official export credits from China amounted to $45 billion.[54]

Since its inception and throughout its rapid expansion, the Chinese solar industry has been heavily export-oriented,[55] selling subsidized Chinese cells and modules at extremely low prices in the United States, injuring the U.S. solar industry and distorting the entire global market for solar products. Moreover, given the massive government support for the solar industry as well as the government's mandate to go abroad, there is every indication that Chinese solar SOEs will further expand their global reach. In fact, state-controlled China National Offshore Oil Corp. recently closed a deal with Spanish solar equipment maker Isofoton SA to create a joint venture to develop solar power projects.[56]

C. <u>Chinese SOEs Pose Strategic and Security Concerns</u>

Because SOEs "often behave as instruments of Chinese foreign policy,"[57] SOE investments and operations in the U.S. market also raise national security and other strategic concerns. The primary motive of SOEs often is not merely economic, but rather to further the objectives of the government, whether it be to obtain advanced technologies, secure access to raw materials, maximize production output or achieve geopolitical influence.

Chinese SOE investments in critical manufacturing and/or defense industries in the United States are troubling, given the precarious nature of the U.S.-China diplomatic relationship. For example, the U.S. steel sector plays a critical role in national defense, and in building and maintaining critical infrastructure. SOE investment in our steel markets could provide foreign governments with direct access to, and information concerning, current and future U.S. infrastructure, energy and defense projects that may be critical to national defense. Moreover, as has been acknowledged by SOEs who attempted to enter the U.S. steel market,[58] such

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at 29 (July 22, 2010) ("In December 2009, Jiangxi LDK Solar was recognized by the PRC government as a 'High and New Technology Enterprise' under the [Enterprise Income Tax] Law and is therefore entitled to the preferential enterprise income tax rate of 15% from 2009 to 2011").

[54] Export-Import Bank of the United States, *Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2011) at 11, available at www.exim.gov/about/reports/compet/documents/2010_Competitiveness_Report.pdf.

[55] For example, in 2008, 2009 and 2010, Chinese solar cell producer Yingli Green Energy sold 97.5 percent, 95.5 percent and 94 percent, respectively, of its products outside of China. Yingli Green Energy Holding Co. Ltd. Form 20-F For Fiscal Year Ended December 31, 2010 at 17, available at http://ir.yinglisolar.com/phoenix.zhtml?c=213018&p=irol-sec.

[56] Yvonne Lee and Aaron Back, *China Reinforces Energy Supplies*, Wall Street Journal (Feb. 2, 2012).

[57] Analysis of Chinese SOEs and State Capitalism at 86.

[58] When Anshan Iron and Steel Group, a company wholly owned and controlled by the Chinese government, proposed to invest in the U.S. market, several of Anshan's justifications for the investment derived from the Chinese government's industrial policies, including acquiring advanced technology and returning the technology to China.

investments could provide foreign governments with potential new technologies in steel production.

In addition, according to the OECD, companies owned by foreign governments or SOEs can effectively act as "Trojan horses," serving as conduits of illicit technology transfers as well as outright espionage. The secrecy of certain U.S. law enforcement efforts could be compromised if such efforts involve the cooperation of companies (*e.g.*, banks or telephone operators) controlled by foreign governments.[59]

At the direction of the Chinese government, Chinese SOEs are also aggressively targeting natural resources through their outward foreign investment, causing concern as to the availability of non-renewable resources for the U.S. economy. "The top Chinese leadership has stated that SOEs will continue to be the main actors in China's ['Going Abroad'] policy, and that China will use its massive foreign exchange reserves to fuel this overseas expansion, especially targeting energy and natural resources."[60] With regard to energy in particular, it is critically important for the United States to maintain its own domestic renewable energy industries and ensure that it does not become dependent on China to fulfill such needs, especially given that the United States already depends on foreign countries for fossil fuels to sustain our non-renewable energy needs. Thus, the Chinese government's control and direction of its SOEs poses a unique set of security and strategic concerns for the United States.

D. Competitive Challenges for U.S. Companies Operating Within China

Most of the above-noted distortions created by China's state capitalist system and SOE involvement in the global marketplace adversely impact the competitive environment in China as well, making it more difficult for U.S. companies to compete on a level playing field in that country. Indeed, the provision of subsidies and other benefits, access to concessionary financing, preferential regulatory treatment, and other privileges and immunities granted to SOEs provide these entities a competitive advantage in their own home market over their private sector competitors. These privileges and immunities are often reinforced with discriminatory market access and government procurement policies that serve to protect favored industries and national champions.[61] Indeed, China has implemented policies that discriminate against certain imported goods, in derogation of its WTO obligation to provide treatment no less favorable than that accorded to domestic like products. China has also restricted foreign investment in certain key industries.

1. Foreign Investment Restrictions in China

China has long restricted foreign investment into its economy, and often uses its SOEs to implement such policies. As noted by USTR, "the Chinese government has… issued a number

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See Wiley Rein LLP, *Facing the Challenges of SOE Investment Abroad* (June 2011) at 12-13, available at http://www.steelnet.org/new/new_body.html.

[59] Corporate Governance of SOEs Operating Abroad at 8.

[60] Analysis of Chinese SOEs and State Capitalism at 89.

[61] Robert D. Hormats, *Ensuring a Sound Basis for Global Competition: Competitive Neutrality*, DipNote: U.S. Department of State Official Blog (May 6, 2011).

of measures that restrict the ability of state-owned and state-invested enterprises to accept foreign investment, particularly in key sectors."[62] For example, China imposes various hurdles to foreign investment in its largely state-owned steel industry. China's 2005 *Policies for Development of Iron and Steel Industry* ("Steel Policy") forbids foreign companies from owning a controlling stake in Chinese steel producers, stating: "For any foreign investment in the iron and steel industry of China, foreign investors are 'in principle' not allowed to have a controlling share."[63] Any foreign investment project in the steel industry that is permitted must first be approved by the Ministry of Commerce, the State Development and Reform Commission ("NDRC"), SASAC, and the China Securities Regulatory Commission (if the investment involves a Chinese listed company), and it must be registered with other relevant authorities.

Such policies have resulted in a steel industry in China which is predominantly state-owned, with the government owning the vast majority of shares in almost all of China's major steel producers.[64] As of 2009, more than 95 percent of the production of the top 20 steel groups in China was subject to some government ownership, and 16 of the top 20 steel groups were 100 percent owned and controlled by the government.[65]

In many sectors where foreign investment is not completely prohibited, the Chinese government imposes various regulations which otherwise hinder foreign investment. USTR found that "China has added a variety of restrictions on investment that appear designed to shield inefficient or monopolistic Chinese enterprises from foreign competition."[66] For example, China continues to impose technology transfer requirements as a condition of foreign investment in many Chinese sectors, despite its WTO commitment not to do so.[67] The government of China continues to exercise control over technology transfers in its review of joint venture applications (pursuant to the *Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures*), as well as in the government's involvement in contract negotiations between Chinese SOEs and foreign investors.[68]

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[62] USTR Report on China's WTO Compliance at 61.

[63] 2005 Steel Policy at Art. 23. This restriction is further corroborated by USTR, which concludes that "foreign investors are not allowed to have a controlling share in steel and iron enterprises in China." *2010 National Trade Estimate Report on Foreign Trade Barriers: China*, U.S. Trade Representative at 3.

[64] The Chinese Government's 10th Five-Year Plan for National Economic and Social Development established the framework for state ownership of the steel industry by requiring that the "state must hold a controlling stake in strategic enterprises that concern the national economy." Government of the People's Republic of China's Report on the Outline of the Tenth Five-Year Plan for National Economic and Social Development (delivered at the Fourth Session of the Ninth National People's Congress on March 5, 2001).

[65] *See The Reform Myth: How China is Using State Power to Create the World's Dominant Steel Industry*, Wiley Rein, LLP (October 2010) at 6-8.

[66] USTR Report on China's WTO Compliance at 68.

[67] *See* WTO Working Party Report on the Accession of China at ¶ 203 ("The allocation, permission or rights for investment will not be conditional upon performance requirements set by national or sub-national authorities or subject to secondary industrial compensation including specified types or volumes of business opportunities, the use of local inputs or the transfer of technology").

[68] *See, e.g.*, *Regulations for the Implementation of the Law on Sino-foreign Equity Joint Ventures* (2001) at Chapter VI, available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=51062.

2. The Role of SOEs in Chinese Government Procurement

Domestic industries in China, and SOEs in particular, enjoy an unfair competitive advantage in China's large and potentially lucrative government procurement market. China has still not acceded to the WTO's Government Procurement Agreement (despite commitments made upon its WTO accession), and USTR notes that China "is maintaining and adopting government procurement measures that give domestic preferences."[69]

Over 60 percent of Chinese government procurement is made through domestic companies, including state-owned or -controlled enterprises.[70] There are several reasons for SOEs' substantial advantage in Chinese government procurement. First, the government of China indicates that "most procurement… is conducted by local governments, which may be predisposed to favor local SOEs who contribute revenues to local coffers."[71] In addition, SOEs have an advantage, especially over foreign competitors, because of the close relationships between the management of SOEs in a locality with local government decision makers. Furthermore, many government procurement opportunities in China are in SOE-dominated industries and, of course, the government has a vested interest in the success of SOEs.[72] Moreover, once SOEs obtain a government procurement contract in China, they are more likely to conduct any related sub-contracting through other SOEs. Thus, China's government procurement system is another means by which the government discriminates against foreign companies, including U.S. companies, in favor of its state-owned and domestic enterprises.

In sum, the increasing involvement of SOEs in markets around the globe threatens to undermine free-market principles and has significant implications for the U.S. and global economies. The policies and actions of the Chinese government, including its support for SOEs, continue to distort world trade and impose tremendous economic costs on the United States, its companies and its workers.

IV. POLICY OPTIONS FOR ADDRESSING THE COMPETITIVE CHALLENGES POSED BY CHINESE SOES

While the United States encourages foreign direct investment, and should continue to do so, the growing involvement of Chinese SOEs abroad presents unique challenges that can harm competitiveness in U.S. and world markets if left unaddressed. The potential for anti-competitive behavior and other distortions will only increase if state actors are allowed to operate abroad without restriction based on their government's direction and funding.

Though a number of countries have implemented mechanisms to discipline SOE investment,[73] additional work is required to confront the growth of Chinese SOE investment abroad. There are

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[69] USTR Report on China's WTO Compliance at 63-64.

[70] Analysis of Chinese SOEs and State Capitalism at 59.

[71] Analysis of Chinese SOEs and State Capitalism at 57.

[72] Analysis of Chinese SOEs and State Capitalism at 57.

[73] These mechanisms include the concept of "competitive neutrality," whereby state-owned and -controlled entities engaged in commercial activities are disciplined by market forces. The Australian Government introduced

currently no adequate tools to address the growth of SOE participation in global markets. Nor are there adequate U.S. laws or mechanisms in place to ensure a level playing field when Chinese and other foreign SOEs engage in commercial activity in the U.S. market. Indeed, while much of the focus has been on ensuring fair treatment and a level playing field in China and other global markets, of equal or even greater importance is the potential adverse impact of SOE investment in the U.S. market.

Most recently, members of the business community have been working with the U.S. government to address these issues in the context of the Trans-Pacific Partnership ("TPP") Agreement. These efforts include establishing new and binding commitments in the TPP Agreement that effectively address the potential anti-competitive effects stemming from SOE investment in global markets. As the TPP Agreement is being touted as the model trade agreement for the twenty-first century, the United States should ensure that tough disciplines on SOE behavior are included – it should not allow further weakening of the SOE provisions. In particular, the United States should insist on language requiring that SOEs investing or operating in the markets of other signatories act based on commercial considerations and that SOEs do not receive subsidies or other benefits from their governments that unfairly advantage them with respect to an investment abroad. While China is not subject to the TPP Agreement, it covers a number of countries in which the state is playing a growing role in commercial activity. The agreement may also serve as a model for future agreements that include China.

Other potential steps to confront the increasing involvement of Chinese SOEs in the U.S. and global markets include the following:

- Continue to address the issue of SOEs through multilateral fora such as the OECD and the WTO. For example, the United States could continue to support the OECD's work on these issues. In addition, USTR should be more aggressive in pursuing a case at the WTO against China for violating its commitments regarding government intervention in the operations of its SOEs.[74]

- Continue to pursue a coherent policy with respect to reducing potential anti-competitive effects of SOEs through model Bilateral Investment Treaty language, Free Trade Agreements, and other bilateral and multilateral agreements. This would include ensuring that SOEs are included as part of China's commitments upon joining the WTO Government Procurement Agreement.

- Advocate for an OECD agreement that establishes and enforces guidelines or "best practices" to ensure that SOEs operate based on commercial considerations. The arrangement could be modeled after the Santiago Principles (regarding Sovereign Wealth

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such a "competitive neutrality" policy in 1995, with the goal of removing market distortions caused by state-owned businesses. Canada has both a national security review as well as a "net benefit" review, which ensures that foreign investment will be a "net benefit" to Canada (including whether foreign SOEs will adhere to Canadian standards of corporate governance and whether the entity will continue to operate on a commercial basis after the SOE acquisition or investment).

[74] Among other things, China committed that it "would not influence, directly or indirectly, commercial decisions on the part of state-owned enterprises." *See* WTO Working Party Report on the Accession of China.

Funds) and the guidelines themselves could be similar to the OECD "Guidelines on Corporate Governance of SOEs."

- The United States should also consider heightened review for incoming investment by state-owned and state-controlled enterprises. Such a review could be in the form of an economic benefit test (*i.e.*, Canada) or could ensure that SOEs are abiding by an established set of rules (*i.e.*, the OECD Guidelines). The review could be designed to ensure that SOEs investing and/or operating in the United States act solely based on commercial considerations and that such SOEs do not receive subsidies or other benefits from their home government that provide them unfair advantages over their U.S. competitors. To target SOEs that operate with significant levels of government support, the provision also could be narrowly tailored to cover only SOE investments from non-market economy countries.

Such efforts to address issues related to SOE investment abroad are all the more important given the recent WTO Appellate Body decision relating to whether SOEs should be considered public bodies for purposes of the CVD law[75] – a decision which raises concerns about the ability to use traditional trade remedy laws to confront unfair trade practices by SOEs.

V. CONCLUSION

By making its SOEs artificially competitive in world markets, the Chinese government has disadvantaged market-oriented producers around the globe, including those in the United States. If these SOEs and their subsidiaries continue to expand their presence overseas to compete in private markets, they are likely to further distort global markets and cause additional harm to U.S. companies and their workers.

While we should not seek to restrict market-based foreign investment, the United States should increase efforts to address the potential market-distorting affects of Chinese SOEs in the U.S. and global markets. Such efforts will ensure that private companies in the United States are able to continue operating in accordance with free market principles.

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[75] *See United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China*, WT/DS379/AB/R, World Trade Organization (Mar. 11, 2011). The Appellate Body found that government ownership alone is insufficient to establish that an entity is a "public body" for purposes of the CVD law. The Appellate Body concluded that, in considering whether an entity is a public body, an investigative authority must consider whether the entity exercises authority vested in it by the government for the purposes of performing functions of a governmental character. *See id.*