Foreign Investment: Another Year of Surprises

Michael Coates

The former Nexen headquarters in Calgary, which once had the company's name on the building. That ended when it was acquired by CNOOC, the Chinese National Overseas Oil Corporation, which has kept all the promises it made to Investment Canada in the takeover, but is also keeping a discreet presence. Shutterstock photo

While Canada finished in second place, after Hong Kong, among the best places in the world to do business, our foreign investment climate isn't simple. Canada's investment policy incorporates a wariness of state owned enterprises and an increasing reliance on the national security test to deter unwanted foreign acquisitions.

It's been just over a year since Prime Minister Stephen Harper revised Canada's foreign investment policy with new rules governing state-owned enterprises (SOEs) and higher review threshold limits. Shortly after those changes were announced, I wrote an article in which I concluded that "each new [foreign] acquisition will likely write a new chapter in [the] unpredictable evolution of Canada's investment policy." Indeed, this continues to be the case.

There have been three major developments over the past year that have driven a further evolution in Canada's investment policy: the decline in Chinese investment since the CNOOC Limited-Nexen transaction; the use of the national security test to screen out or deter unwanted investors; and a further adjustment to Canada's foreign investment review thresholds.

The growth of Chinese foreign investment is raising public policy concerns around the globe. Canada is not the only democratic country trying to reconcile the need to develop Chinese trade and investment relationships with the politics of working with a regime where the rule of law is secondary to party policy.

Although Canadian officials are loath to admit this publicly, most will privately acknowledge it is investment from China that motivated the creation of new guidelines that restrict SOE investment in the oil sands. According to the Bank of Montreal, Chinese SOEs currently account for ownership of 10 per cent of the total reserves in the oil sands, with other SOEs accounting for an additional two per cent. Some critics of the new SOE guidelines have publicly expressed concern that restricting SOE enterprises has resulted in a cooling off of potential Chinese investment. Former industry minister Jim Prentice, now vice chairman of CIBC, said in a speech last fall that it is "troubling… that investment by Chinese SOEs in Canada's oil and gas sector, which between 2005 and 2012 totaled some $33 billion, has now essentially stopped." He added that large SOEs have emerged as a dominant form of international capital, especially in the energy sector, and Canada should not be intimidated by their presence.

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Prentice's views may not be shared unanimously in Canada's business community. In implementing the new SOE guidelines, the government was responding to vocal domestic concerns raised by industry, academia, NGOs and in the media. It is a little known fact that there was a powerful lobby of Canadian oil interests who encouraged the federal government to let the Nexen-CNOOC deal proceed, but only if restrictions on further SOE investment were implemented. Some in Canadian industry claimed to be very concerned about what they saw as the capital cost advantages SOEs have over the private sector. Others said that keeping SOE investment out makes it easier for Canadian companies to acquire properties.

This debate is being replicated elsewhere. In 2012, US President Barack Obama blocked Chinese interests from acquiring four wind farm projects in northern Oregon near a Navy base where the US military flies unmanned drones and electronic-warfare planes on training missions. In Australia, there has been much public debate over Chinese investment in agricultural properties. Indeed, *The Economist* noted last year that, since the 2008 global financial crisis, all countries seem to be putting up barriers to trade and foreign investment. But it is Canada, the United States, and Australia who seem to have the greatest concerns about China.

One voice of reason in this debate has been that of Kevin Lynch, former Clerk of the Privy Council and current vice chair of BMO Financial Group. Lynch points out that it is not the ownership of capital that the government should be primarily concerned with but the behaviour of capital. For example, to date, CNOOC has kept every promise it made to the Canadian government, including obtaining a listing on the TSX despite being very thinly traded. CNOOC felt strongly that it should operate in the same regulatory environment as other publicly traded companies in Canada. Contrast this with another recent foreign investor, US Steel, which after making explicit employment and operational undertakings to the federal government when it acquired Stelco, closed most operations within a year, settled a messy lawsuit with the government, and announced last fall that it was permanently closing its Canadian operations.

Meanwhile, the Chinese government appears to be aware of growing barriers to outbound investment by SOEs and is moving to address them. Reforms adopted in November mean China is countering any perceptions of capital cost advantages by tacking additional taxes onto SOE profits. By 2020, Chinese SOEs will be expected to hand over 30 per cent of their profits as dividends to the central government. Private-sector business will also be given greater opportunity to invest in SOEs and do business in areas dominated by them.

Moreover, the impact of the Canadian government's SOE guidelines may have been overstated, at least with respect to activity in 2013. The past year was not exactly a buoyant time for M&A activity anyway—although one could argue that the SOE guidelines have compounded this problem. Foreign investment in the oil and gas and mining sectors is down significantly, both in the number of transactions and their value. According to PWC's Capital Markets Flash published in October 2013, there were $8 billion in transactions for the first nine months of 2013, versus $66 billion for the same period in 2012, while the value of transactions across all of Canadian industry was off by six per cent.

In an effort, perhaps, to divert from the public domain some of the discussion about controversial proposed acquisitions, the government started using "national security" in earnest as a screening mechanism for foreign investment in 2013. In a much-discussed case last fall, the government formally rejected the acquisition of the Allstream Division of Manitoba Telecom Services Inc. by the Egyptian investment group Accelero Capital Holdings. From what we can decipher from Minister James Moore's statement on the matter, the government was concerned about the national security implications of a foreign buyer operating a national fibre network that provides critical telecommunications services to the Government of Canada.

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Soon after that, the government also made it clear that it was not comfortable with a possible sale of BlackBerry to the Chinese computer-maker Lenovo or any other state-influenced acquirer. In comments issued a day after Lenovo signed a non-disclosure deal to examine BlackBerry's books, the prime minister invoked the national security test when he said that BlackBerry is "a very important player in the IT sector and the advanced information-technology and communications sector…. So it would be very important that any transactions involving BlackBerry in the future not lead to any concerns about security in that particular area of the economy." What is noteworthy here is that the government opined on a potential investor before it even had the opportunity to submit an application. The upside for the government and the aspiring investor, however, was that both were able to avoid a potentially embarrassing and protracted public debate.

The continued use of national security as a screen of foreign investment has the added benefit of not requiring the government to provide any specific reasons for its concerns. In this regard, the Canadian government has clearly taken note of how the Committee on Foreign Investment in the United States (CFIUS) is able to effectively bury potentially controversial acquisitions under the rubric of national security. Expect to see more of this—or, rather to "not see" more of this.

While most commentators were focused on the restrictions on foreign investment, 2013 ended with an important liberalization of the threshold level at which all investments by non-SOEs are reviewed. The federal government restated its openness to foreign investment in the speech from the throne, and it is clear now that it was the effect of looming provisions of the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU on other free-trade agreements that underpinned this.

As part of CETA, Canada agreed to increase the foreign ownership threshold limits for all European transactions to C$1.5 billion over the two years after the agreement comes into effect. Due to grandfathering provisions in all of our major free-trade agreements such as NAFTA, our other favoured trading relationships will automatically be granted the same privileges. Significantly, however, SOE thresholds are not affected and remain fixed at $344 million.

Based on country of origin, the practical implication of this policy change is that, within a few years, the vast majority of foreign investments will be executed without a review. For example, at the end of the summer, American-owned Louisiana-Pacific completed a billion-dollar transaction with B.C.'s Ainsworth Lumber, yet this relatively small and uncontroversial transaction is already well past a typical review period as the government awaits competition regulatory rulings in Canada and the United States. Two years from now, this sort of laborious Investment Canada review process for a similar-sized transaction could be a thing of the past.

The government appears to have come to the conclusion that it is only interested in reviewing very large transactions that will attract public interest, unless they are proposed by SOEs. Even so, if there is a transaction below the $1.5-billion threshold level that even remotely has national security implications, the government can still invoke the national security test to screen out unwanted investors, as there are no threshold limits attached to that.

The recent controversies surrounding foreign investment have proved embarrassing for both the government and prospective investors. It is very difficult for the government to say that it is open to investment if it is creating new rules to thwart it. As Prentice pointed out in his speech last fall, it is awkward for investors to come into a country knowing that they may well encounter "an embarrassing confrontation" with the government and be the source of a major public debate.

The current Investment Canada review process, with its legislated timetables, can turn a foreign investment into a "competition" that media love to cover. Companies and governments now feel compelled to increase the types of undertakings they are making to demonstrate their commitment to the Canadian economy, and indeed to society. In some cases, these commitments go far beyond capital and employment guarantees for the company they wish to acquire. Undertakings now commonly include obtaining a listing on the TSX, establishing regional headquarters or world product mandates, and making philanthropic donations—all in an attempt to pass a public litmus test about the benefits of foreign ownership. The contracted duration of all of these undertakings is also lengthening. None of this is helpful in demonstrating that Canada welcomes foreign investment.

By the end of 2013, the prime minister was continuing to defend the government's foreign investment policies by saying it would be "foolish to provide absolute clarity" when it comes to investment guidelines. Clearer rules may provide less risk to investors, but the government believes it is more politically vulnerable if transactions like the PotashCorp or CNOOC deals capture the attention of the public. Moreover, the prime minister's continued reservations about SOEs were clearly articulated in November when he said "…we would welcome foreign direct investment of all kinds…. but I don't think as Canadians we would want to see entire sectors of the Canadian economy become predominantly state owned by a foreign country…. I don't think that's good for the Canadian economy. It's not the kind of model we're seeking."

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Looking at the policy changes overall, it is apparent that any foreign transaction of significant size will continue to carry a high level of political risk if it becomes part of public discourse. This is particularly true if the transaction is by a SOE, and even more so if it is a Chinese SOE. We can also expect the continued use of the national security test to screen out unwelcome investors owing to the lack of justification required by the government.

There is unlikely to be any deviation from this tactical approach to policy making as long as the current government is in power. The prime minister is clear: he wants flexibility in the rules. The question remains, however, as to whether there is enough predictability in the rules to entice foreign investment. P

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