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UNCTAD RESEARCH PARTNERSHIP PLATFORM

COMPETITIVE NEUTRALITY AND ITS APPLICATION IN SELECTED DEVELOPING COUNTRIES

UNITED NATIONS

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD Research Partnership Platform Publication Series

Competitive neutrality and its application in selected developing countries

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UNITED NATIONS

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Geneva, 2014

Note

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Foreword on the Research Partnership Platform

Considering the important role of research and policy analysis in the development of appropriate policies and legislation responding to the challenges faced in the area of competition and consumer protection, UNCTAD created the **Research Partnership Platform (RPP)** in 2010. The UNCTAD RPP is an initiative that aims at contributing to the development of best practices in the formulation and effective enforcement of competition and consumer protection laws and policies so as to promote development. The RPP is directed by Hassan Qaqaya and managed by Graham Mott.

The RPP brings together research institutions, universities, competition authorities, business and civil society, and provides a platform where they can undertake joint research and other activities with UNCTAD, exchange ideas on the issues and challenges in the area of competition and consumer protection faced particularly by developing countries and economies in transition. Currently, the Platform hosts over fifty institutions consisting of research institutes, universities, non-governmental organisations, corporate affiliates and competition agencies.

The role of UNCTAD is to facilitate and provide guidance on the research and analysis, as well as other activities, to be undertaken by members of RPP. UNCTAD benefits from the research findings in responding to the challenges faced by developing countries through its technical assistance and capacity-building activities.

This book is the inaugural publication in the UNCTAD RPP Publication Series.

Executive Summary

The potential impact of government on the operation of markets is significant. In addition to enacting laws, and developing and implementing government policy at various levels, a government may play a substantial role as market participant in its own right or by way of corporations or other entities which it owns, controls, or has the capacity to substantially influence. This affects the nature and workings of the markets in which these bodies are involved and impacts on private competitors who may otherwise be more effective market participants.

The place of government within markets of individual countries depends upon a range of factors which include the history, size, political ideology and stage of development of the jurisdiction. Industrial policies adopted by governments on a large or small scale may also advantage government bodies as well as other market participants. In many countries the traditional role of government as a market player is accepted without question. Other nations now question this status quo and question the ability of government to deliver goods and services to markets in the most efficient and beneficial way. This is particularly where they seek to benefit from the efficiencies and innovations which a market economy can deliver to the economy and to consumers.

Theories of competition assume that market participants compete from a level playing field in the sense that none are given advantages which would allow them to win market share from more effective private competitors. Governments and government ownership have the capacity to advantage their market participants in a number of ways. Anti-competitive behaviour can be the subject of competition laws, and the activities of government may be caught by competition laws to a greater or lesser extent depending upon the way that the competition laws are drafted. Competition laws, however, only attack prohibited anti-competitive behaviour, and many of the advantages of government bodies are outside their scope. Advantages may be significant and overt or subtle: as simple as no requirement to pay tax or comply with regulations, or easier access to finance because of government backing. In many cases the purposes of laws and regulations can be achieved in a number of ways which do not necessarily favour government businesses or lessen competition. While governments may take differing views on the way that they should be involved in markets, it is likely that unfettered involvement without thorough consideration will impact on market competition. Importantly, where governments have traditionally been entrenched in markets a continuing role may be assumed and the impact on competition may not even be the subject of any consideration.

Policies designed to eliminate government advantages of this kind are termed Competitive Neutrality (CN) policies. The approach of an individual jurisdiction to CN policy will be affected by issues including its views on the appropriate level of government involvement in its markets, and the role that industrial policy plays. CN may not be appropriate in all circumstances, particularly where it impedes achievement of important social goals, but there should be recognition that a failure to implement CN has market impact and ultimately has the capacity to affect efficiency gains arising from competition. For this reason, giving preference to government in the market or unwittingly allowing it should be considered by governments and regulators. Claims of public interest should be assessed against pre-determined principles to determine that the best outcomes are achieved either generally or as part of some specific CN policy.

This book is the result of research conducted by the UNCTAD Research Partnership Platform into the issue of competitive neutrality in a number of countries, and the potential for further development of CN in these jurisdictions. A number of jurisdictions responded to the original call for participation, and detailed research was completed by regulators, academics or practitioners from China, India, Malaysia, and Vietnam. These countries are at different stages of economic development, but all are characterised as developing countries. The research reviews approaches within these countries against existing principles and research and the background of CN policy in Australia, which is a developed country with a strong and well enforced competition law. In Australia a structured approach to CN with a well-defined complaint mechanism has operated for a number of years. There was no assumption, however, that this was the only approach or one which would be feasible or appropriate in other jurisdictions.

Additional material from authors on China and Malaysia, and part of the material on Vietnam, addresses the telecommunications industry in each of those jurisdictions as an example of developments in the CN area. Other material addresses the issue of CN in an international context and details the ways that it is being approached in relation to international trade, which has been a subject of considerable debate internationally because a failure to employ it by a country may significantly impact on competition in other jurisdictions rather than just on markets in its own country.

The research shows that most jurisdictions have considered the issue of CN in developing their markets. They have, however, approached the issue in vastly different ways. Vietnam seems to be slower than the others and in fact seems to be increasing the advantages given to government bodies in some markets. China, India and Malaysia have adopted some mechanisms to deal with government in their market reform. India is most comprehensive, recognising the ineffective role of many government bodies in its economy which had previously had very significant government involvement. China's socialist market economy is increasingly opening up to market development but industrial policy is important and influences the developments of markets, particularly in some industries which it categorises as sensitive or essential. In this sense its development is truly state-driven rather than market led. By way of contrast, India, where government traditionally played a substantial role in markets, has exited most of its involvement, recognising that in its particular case government involvement was not delivering the best outcomes for its citizens. It also has a very comprehensive application of competition law to activities of government.

Further useful research might explore in detail approaches adopted by other developing countries, the perceived effectiveness of the current approach in the subject countries, and revisit them to assess the value of these further down the track and chart their next steps.

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Acknowledgements

This UNCTAD publication is a result of an UNCTAD RPP project directed by Deborah Healey and backstopped by UNCTAD staff members by Ebru Gökçe and Graham Mott.

The editors are grateful to Bruno Antunes, Alberto Gabriele and David Vivas Eugui for their support and inputs on the overall structure of the book. Thanks to Karen Tucker for the formatting of this publication.

Special thanks are due to all the authors for their generous contributions to this book.

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Competitive Neutrality: The Concept

Deborah Healey*

1. Introduction

Government has a substantial impact on markets. Laws and regulations designed to promote important public policy goals may, for example, distort markets and affect competition.[1] Government bodies competing with private companies have advantages because of their government links even when competition laws apply, leading to pricing which does not fully reflect the cost of resources. This distorts decisions about production, consumption and investment by government bodies, private competitors and potential competitors.

There are a number of ways in which these issues can be addressed and approaches differ between jurisdictions. As far as anti-competitive regulation is concerned there are usually a number of ways to achieve a policy goal. As consumers are generally better off when markets are more competitive, rules and regulations should be assessed for their impact on competition.[2] Choices which minimise anti-competitive outcomes clearly assist efficiency and competitive markets.

Competitive neutrality (CN) policy initiatives directly address the market advantage of government businesses. CN policy recognises that government business activities that are in competition with the private sector should not have a competitive advantage merely by virtue of government ownership and control. Market advantages in this context manifest in a number of ways. Distortions by advantaged government business enterprises may be direct and clear-cut or more subtle. In Australia, for example, it was recognised that these advantages were:

> less deliberate and transparent, and typically flow from a failure to reform laws, policies and practices to keep abreast of developments as bureaucratic and monopolistic enterprises move to more commercial and competitive operating environments.[3]

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[1] See Sokol, D. Daniel (2012), 'Anticompetitive government regulation', in Ioannis Lianos and D. Daniel Sokol, *The Global Limits of Competition Law*, Stanford University Press, Stanford.

[2] See http://www.oecd.org/competition/assessment-toolkit.htm, which provides a template for consideration of such issues in a jurisdiction and was originally based on the Australian approach to regulatory review.

[3] AGPS (1993), *Report by the Independent Committee of Inquiry into National Competition Policy*, Canberra (the 'Hilmer Report'), p. 295: http://ncp.ncc.gov.au/docs/National%20Competition%20Policy%20Review%20report,%20The%20Hilmer%20Report,%20August%201993.pdf.

However, in some jurisdictions, particularly in developing economies, government has historically occupied such an important place in markets that these more subtle distortions are not at the forefront of consideration during periods of regulatory and organisational reform. Where industrial policies prevail, the critical question is often whether and to what extent the (often new) competition law will actually apply to government bodies. In these jurisdictions it is essential to consider CN in all its manifestations as a very important issue affecting competition. Government accountability and corporatisation are important first steps. Transparency and good governance are important features of a level playing field for competition.

In addition to these other mechanisms, CN policy is a 'regulatory framework (i) within which public and private enterprises face the same set of rules and (ii) where no contact with the state brings competitive advantage to any market participant.'[4] CN policy is based on the assumption that markets which are competitively neutral foster a 'level playing field', which allows resources to flow to efficient producers, regardless of whether they are privately-owned or government-owned. This ultimately maximises consumer welfare.

Adoption of a CN policy may bring other benefits to an economy in addition to fostering a more competitive environment. It may force government businesses to be more efficient. It may also increase government transparency and address private competitor concerns about equity and the level playing field. It may assist government to assess realistically whether it should continue in a particular business. Arguably, CN is a minimum condition for effective markets where government businesses are competing.

Policies to deal with CN issues can be introduced into an economy in a variety of ways. How this is done is a matter for each jurisdiction and will depend upon the development stage of the economy, the degree of government involvement in the market and the approach the state takes to its role in the market. Issues such as the importance of industrial policy in a particular jurisdiction, for example, may impact on the way the state views its participation in markets.[5] Development of a CN policy for a jurisdiction involves the implementation of steps which will ensure that government business advantage does not occur where governments compete with the private sector (or where effective competition could occur) or that government advantage only occurs in limited, well-justified circumstances.

Many countries have enacted competition laws. The extent to which competition laws apply to the activities of government is a threshold CN issue. Competition laws, however, are only part of the resolution of CN. They prevent overt anticompetitive conduct by government

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[4] OECD (2009), 'Policy Roundtables, State Owned Enterprises and the Principle of Competitive Neutrality', Introduction: http://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/50251005.pdf.

[5] Industrial policy involves state intervention in markets by policies influencing demand and supply or by restructuring or other regulation aimed at influencing the market.

bodies but do not ensure a level playing field for competition between government businesses and private enterprises because they do not address other advantages which might accrue to government businesses, both obvious and more subtle.

Methods of ensuring that government bodies do not obtain an advantage over private enterprises include corporatisation, privatisation, effective governance and improving independence, accountability and disclosure.[6] Ex post laws such as EU Art. 106 and related provisions are one approach. Ex ante, the implementation of a CN framework is an effective means of addressing the issue. In some jurisdictions competition advocacy provides a constructive option. Australia introduced a comprehensive framework in the 1990s which has been effective and is considered in more detail later in this chapter. The United Kingdom has also addressed the issue[7] and other jurisdictions have adopted different approaches.[8]

Importantly, CN does not need to be an absolute. It may not be appropriate in circumstances where it hampers the achievement of important societal goals but where claims of public interest are made they should be subject to objective consideration and determination along pre-determined lines. In some circumstances the benefits of a CN initiative would not outweigh the negative impact of its implementation and this needs thorough consideration. CN may be in direct contrast to other policies which prevail in some jurisdictions, such as industrial or socialist policies.

2. The UNCTAD Research Partnership Platform CN Project

This project was one of the first conducted under the UNCTAD Research Partnership Platform established in 2010. The project set out to explore the role of government in markets, the impact of this role on competition, whether CN was the subject of consideration and how CN might be approached. Participants were encouraged to analyse the way that government bodies might impact on effective competition in their own jurisdictions, whether steps were being taken to address this issue and what might be done to improve CN outcomes. A variety of sources, including information about approaches adopted in other jurisdictions, was provided to participants.

At the outset in 2011, a number of jurisdictions volunteered to participate and completed initial questionnaires. Participants in the first phase of the project were asked to address key questions such as:

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[6] See OECD (2012), 'Competitive Neutrality: A Compendium of OECD Recommendations, Guidelines and Best Practices': http://*www.oecd.org/daf/ca/50250955.pdf*.

[7] 'OFT Competition in Mixed Markets: ensuring competitive neutrality', working paper July 2010: http://www.oft.gov.uk/shared_oft/economic_research/oft1242.pdf.

[8] Steps taken in other jurisdictions are set out in OECD (2012), 'Competitive Neutrality A Compendium of OECD Recommendations, Guidelines and Best Practices'.

- What are the nature of SOEs and other government bodies in your jurisdiction? (together 'SOEs')
- Are there many or few?
- What is the nature of their legal personality and control?
- Are there special laws which apply to them?
- What are their governance arrangements?
- Have governance arrangements been reviewed at any point for transparency and to take a market view?
- Are these bodies currently covered by competition law? If they are less than fully covered, what activities are covered?
- Have any mechanisms dealing with competitive neutrality been implemented?
- If they have, do they involve:
  - Break up and corporatisation
  - A focus on governance
  - Another competitive neutrality framework?
- Once SOEs are competing, do they have competitive advantages or disadvantages because of their ownership?

In the second phase of the project, participants were asked to select two government bodies for individual consideration. This involved analysis of the earlier questions specifically in relation to those bodies. They were then asked to identify:

- Any advantages or disadvantages of government ownership or control; and
- If there was net competitive advantage.

A smaller number of participants undertook this task. They were asked to identify ways in which advantages linked to state ownership and control might be removed to create a level playing field between state and non-state competitors. They were also asked whether there were existing complaint mechanisms in relation to CN in their jurisdiction and what other steps had been taken to address these issues.

Ultimately participants from China, India, Malaysia and Vietnam completed the project in a comprehensive fashion, along with additional contributors who explored particular industries in those jurisdictions. Finally, other contributors considered the issue of CN from a global perspective, which has been the subject of considerable comment and debate more recently. None of the participant jurisdictions are OECD members. All are developing countries.

This publication thus reflects the contributions of the participants and outlines their views about the role of government in the market and about CN.

I was invited to lead the project based on my knowledge of the comprehensive approach to the issue of CN in Australia. I thank all of the participants who so willingly gave their time and energy, and contributed so much to the outcome. I particularly thank Ebru Gokce at UNCTAD who was originally involved in the project, for her hard work in getting it off the ground. I would also like to thank Graham Mott at UNCTAD for his unbridled enthusiasm for the project, for his hard work in bringing the project to fruition and his most significant written contribution. I thank Hassan Qaqaya for recognising the need for this project, and for his substantial encouragement to complete it. Any errors are however mine.

The remainder of this introductory chapter first explains the Australian experience to demonstrate how a comprehensive approach to the issue of CN can be adopted. It then briefly analyses some of the findings and views of project participants. The chapters which follow provide the views of the participants.

3. Competitive Neutrality Policy in Australia

3.1 *Overview*

In the mid-1990s, Australia implemented broad-ranging reforms to its competition law and policy which were directed at creating a true national market in a federation of states and territories, and at implementing a more effective competition policy framework. The aim of the reforms was to improve efficiency, increase productivity and encourage innovation. The reforms followed a comprehensive review of competition law and policy which emphasised that competition policy incorporates a range of laws and policies in addition to competition law. The outcome of the review, the Hilmer Report, concluded that an effective National Competition Policy (NCP) for Australia should address six particular concerns, one of which was CN in circumstances where government businesses competed with the private sector.[9]

The NCP reforms[10] included extended coverage of competition law to all businesses throughout the country (including government businesses); significant restrictions on the ability of any jurisdiction to exempt business from competition law by other laws and regulations; and other amendments to competition law itself.[11] They also included the implementation of a number of other structural and procedural mechanisms: commitment

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[9] Hilmer Report. The others were the anti-competitive conduct of firms (and their incomplete coverage under competition law); unjustified regulatory restrictions on competition; inappropriate structures of public monopolies; denial of access to essential facilities and monopoly pricing.

[10] The reforms were implemented under a series of intergovernmental agreements between the Commonwealth, the states and territories: Competition Principles Agreement; Conduct Code Agreement; Agreement to Implement National Competition Policy and Related Reforms. A National Competition Council was established as part of these reforms to provide advice about competition policy matters and make various recommendations in relation to the statutory access regime contained in Part IIIA of the TPA.

[11] The competition law was called the Trade Practices Act 1974 at the time of the review. The Australian competition law is now called the Competition and Consumer Act 2011; it is a further amended and renamed form of the Trade Practices Act 1974.

by the Commonwealth and state governments to review all laws restricting competition; structural reform of public monopolies to facilitate competition; a scheme for third party access to significant infrastructure facilities; and some price oversight. [12]

Most importantly for the purposes of this chapter, the reforms introduced a comprehensive, systematic and nationally consistent[13] CN programme which would result in Australia being recognised as the only country which has both a 'commitment and a complete enforcement mechanism' for CN.[14]

At the time of the review the government had traditionally delivered many services, such as utilities, transport and telecommunications. Pricing practices and productivity in a number of industries were assessed as generally being poor and ineffective.[15] The differential treatment of government businesses was also judged to be detrimental to competition and productivity. Reforms such as corporatisation,[16] commercialisation, privatisation, competitive tendering and competitive contracting had begun prior to NCP.[17] Despite this the Hilmer Report recommended a comprehensive programme of reforms to counter problems arising from government ownership. Significantly, it recognised that:

> by far the most systematic [market] distortions appear to arise when government businesses participate in competitive markets. In particular, government businesses were often seen as enjoying a unique set of competitive advantages by virtue of their ownership, including exemption from tax.

The Hilmer Report identified common advantages of government businesses as:

> immunity from various taxes and charges; immunity from various regulatory requirements; explicit or implicit government guarantees on debts; concessional interest rates on loans; not being required to account for depreciation expenses; not being required to achieve a commercial rate of return on assets; and effective immunity

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[12] A body called the National Competition Council was established to oversee the implementation.

[13] See Hilmer Report, p. 293.

[14] OECD (2014), 'Competitive Neutrality: National Practices in Partner and Accession Countries', p. 8: http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/CA/SOPP(2013)1/FINAL&docLanguage=En.

[15] National Competition Council (1997), 'Competitive Neutrality Reform: Issues in implementing clause 3 of the Competition Principles Agreement', p. 2: http://www.ncp.ncc.gov.au/docs/PICo-001.pdf.

[16] Hilmer Report. p. 300 recognises that 'corporatisation' alone would not fulfil the requirements of an appropriate model. The model required embodies five basic principles: clarity and consistency of objectives; management authority and accountability; performance monitoring; effective rewards and sanctions; and competitive neutrality.

[17] See also Commonwealth Authorities and Companies Act 1997, and Financial Management and Accountability Act 1997. New consolidated regulation, the Public Governance, Performance and Accountability Act and attached rules become fully operational on 1 July 2014.

from bankruptcy. In some cases a government business will also operate in monopoly and competitive markets, presenting opportunities for cross-subsidisation.[18]

Competitive disadvantages of government businesses identified included greater accountability obligations, community service obligations, reduced managerial autonomy and requirements to comply with various government policies on wages, employment and industrial relations. The Hilmer Report also recognised that in some situations it is difficult to determine the net competitive advantage or disadvantage of particular activities with any precision.

The Australian, state and territory governments agreed to a set of policy principles to implement CN supported by institutional arrangements.[19] The reforms were expected to deliver more efficient pricing, with resources allocated to their best uses; longer term performance efficiency gains as a result of competition; savings to government from better use of infrastructure; transparency and greater efficiency in the provision of community service obligations; and increased service quality as a result of better performance monitoring.[20] Other identified advantages of CN include increased private-sector participation in industries, the promotion of a dynamic culture within government businesses and greater efficiency, better services and cost-reflective prices for users.[21]

In traditional monopoly markets the Hilmer Report identified different competitive neutrality concerns. In markets opened up to competition it was clearly not appropriate for government

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[18] Hilmer Report, pp. 296-7.

[19] The principles adopted in relation to competitive neutrality were:

- Government business should not enjoy any net competitive advantage by virtue of their ownership when competing with other businesses.
- Government businesses competing against other firms within their traditional markets should be subject to measures that effectively neutralise any net competitive advantage resulting from their ownership. Unless exceptional circumstances exist, those advantages should be neutralised within one year of the introduction of competition:
    a. where the government business has traditionally provided services directly to the public there should be a presumption that this be achieved through corporatisation; and
    b. where the government business has traditionally provided services only to other government entities, this may be achieved through corporatisation or the application of effective pricing directions.
- Government businesses should not be compete against other businesses outside their traditional markets without being subject to measures that effectively neutralise any net competitive advantage flowing from their ownership. No transition period should be permitted in this setting:
    a. where the government business has traditionally provided services directly to the public there should be a presumption that this be achieved through corporatisation; and
    b. where the government business has traditionally provided services only to other government agencies, this may be achieved through corporatisation or the application of effective pricing directions. (Intergovernmental Competition Principles Agreement).

[20] National Competition Council (1997), 'Competitive Neutrality Reform: issues implementing clause 3 of the Competition Principles Agreement', p. 2.

[21] National Competition Council (2003), 'Assessment of Government Progress in Implementing the National Competition Policy and Related Reforms': http://ncp.ncc.gov.au/docs/2003%20assessment.pdf.

businesses to enjoy continuing advantages against newer and possibly more efficient competitors. Where government businesses enter new markets they may take business from more efficient competitors if CN issues are not addressed.

No Australian government had adopted the policy that its businesses must be corporatised before they could compete with private firms, and while corporatisation was recognised as the core response to problems of government advantage, it was accepted that this would not be appropriate in all cases. Where privatisation or corporatisation was not practical, the Hilmer Report states that the full economic costs of resources deployed must be reflected in pricing. Under this approach:

> government businesses would be required to account for costs incurred by the business itself (such as wages), other associated costs (such as accommodation) and implicit costs (such as commercial rate of return and income tax equivalents).[22]

While not as effective as privatisation or corporatisation, accounting measures are a useful approach to address issues of advantage.

The Hilmer Report recommended the establishment of an independent national body, the National Competition Council, to develop and refine these principles, and to report on progress with this and all other NCP reforms over a ten year period. The NCP scheme provided for payments by the Commonwealth government on satisfaction of obligations under the scheme, with the NCC able to withhold payments to individual states and territories where progress was unacceptable on any issue. The incentive to comply with the NCP requirements was therefore very strong. This financial incentive was a particularly important factor in the success of NCP, and in particular, of CN policy.

The CN policy was formally implemented under the Intergovernmental Competition Principles Agreement, signed by the Commonwealth, state and territory governments.[23] Amongst other things, the signatories expressly agreed to impose on significant government business enterprises[24] in the category of Public Trading Enterprises and Public Financial Enterprises[25]: full commonwealth, state and territory taxes or tax equivalent systems; debt guarantee fees directed towards offsetting the competitive advantages of these; and any regulations which

[22] Hilmer Report, p. 302.

[23] The Intergovernmental Competition Principles Agreement was signed on 25 February 1994. See: http://www.coag.gov.au/node/52. The competitive neutrality obligations are part of Clause 3.

[24] 'Significant' in this context is not just a measure of the size of a business but also its influence on the relevant market, and its contribution to the economy at its own level. A full and detailed list of the types of business activities which the NCC thought 'should be considered for competition reform' in this context appears in National Competition Council (1997), p. 11.

[25] These bodies included major commodity marketing authorities, electricity authorities, railway authorities, port authorities, water and sewerage businesses, government-owned banks and government-owned insurance companies.

private sector businesses were normally subject to, such as those relating to the protection of the environment, planning and approval processes.[26] Other agencies undertaking significant business activities as part of a broader range of functions were to implement these processes if appropriate, or at least ensure prices charged for goods or services take those issues into account and fully reflect cost attribution for the activities.[27]

This approach to CN was to be implemented 'only to the extent that the benefits to be realised from implementation outweigh the costs.'[28]

CN processes were established in the Commonwealth and in each state and territory (see below).

Subsequently, as part of on-going assessment of competition policy, under the Competition and Infrastructure Reform Agreement between the Commonwealth, states and territories in 2006,[29] the CN obligations of the participating jurisdictions were extended to include transparent reporting and other obligations for government 'business enterprises engaged in significant business activities'.[30] While CN progress and the handling of CN complaints had always been reported within the individual jurisdictions, the new requirements obliged each jurisdiction to formally report to the group. This increased accountability was intended to ensure effective compliance with existing obligations.

3.2 *Implementation of CN policy*

In practical terms, the application of CN requires government business pricing decisions to be made in a comparable manner to those of private sector organisations by, first, identifying all direct costs and adding CN components where necessary.[31] The second step requires adjusting for relevant costs or margins that apply in the private sector and may not be fully accounted for in the direct costs to government, including commercial rate of return, payment of all relevant Commonwealth and state taxes, regulatory neutrality and debt neutrality. The factoring in of community service obligations (CSOs) is an important

[26] Intergovernmental Competition Principles Agreement, clause 3(4).
[27] Intergovernmental Competition Principles Agreement, clause 3(5). This classification varies from jurisdiction to jurisdiction, as a business activity may be operated on a commercial basis in one jurisdiction but be part of government in another jurisdiction. See OECD (2012), 'Competitive Neutrality: Maintaining a level playing field between public and private business', p. 11, which describes the way that business activities are assessed in Australia.
[28] Intergovernmental Competition Principles Agreement, clause 3(6).
[29] For full details of this development see: http://archive.coag.gov.au/coag_meeting_outcomes/2006-02-10/index.cfm.
[30] See for example '2010-2011 Heads of Treasuries Competitive Neutrality Matrix Report', June 2012: http://archive.coag.gov.au/coag_meeting_outcomes/2006-02-10/index.cfm. It contains a detailed report on compliance with CN principles for all government businesses in the Commonwealth, states and territories.
[31] See Commonwealth Competitive Neutrality Guidelines *(*1998), p. 7.

consideration. However, under CN policy, CSOs can only be implemented on a non-commercial basis at the explicit direction of legislation, Cabinet decision or public directions from shareholder Ministers.[32] This process allows for consideration of the true cost to the community of these CSOs.

Decisions on whether particular CN reforms are appropriate are guided by the assessment that the benefits of a particular reform outweigh the costs, in accordance with the Intergovernmental Competition Principles Agreement.[33] Factors which might be relevant include matters relating to the interests of consumers, the competitiveness of business generally, ecologically sustainable development, social welfare and equity, industrial relations, occupational health and safety, access and equity, economic growth and regional development, and the efficient allocation of resources.[34]

The term 'net competitive advantage' (NCC) is thus central to the concept of CN. NCC does not mean that 'advantages' in one area compensate for 'disadvantages' in another, as the weighing up involved in these circumstances is unlikely to lead to efficient resource allocation. Each case must, rather, be considered individually.[35]

3.3 *Complaints procedures*

Complaints are investigated by independent bodies in the Commonwealth and each state and territory jurisdiction. Processes involve an independent arbitrator who gives formal reasons for their judgement and prompt rectification of any legitimate issues by the body concerned.

A relatively small number of complaints about breach of CN principles have been made in the Commonwealth, the states and the territories.[36]

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[32] See Commonwealth Competitive Neutrality Guidelines (1998), p. 19.
[33] Intergovernmental Competition Principles Agreement, clause 1(3).
[34] See National Competition Council (1997), p. 12.
[35] Trembath, A. (2002), 'Competitive Neutrality: Scope for Enhancement', National Competition Council Staff Discussion Paper, AusInfo, Canberra 13. The author notes that the following issues were clarified by COAG in November 2000:

- Government businesses not subject to the executive control of government, such as universities, could take a 'best endeavours' approach;
- a range of costing methods constitute 'full cost attribution' (for example, fully distributed cost, marginal cost and avoidable cost);
- competitive processes were not required for delivery of CSOs, and governments are free to determine who receives payments or subsidies, but they must be transparent, costed and funded directly by government.

[36] For a discussion of a larger number of competitive neutrality reviews in the Commonwealth, the states and territories, see Healey, D. (forthcoming). 'Competitive Neutrality: Addressing Government Advantage in Australian Markets', in Drexl J. (ed), *State Initiated Restraints of Competition*, Cheltenham, UK, Edward Elgar.

One example of note illustrates the approach to CN review in a complex regulatory environment: the implementation of the Australian broadband network. In 2011, three competitors complained about the conduct of NBN Co., a company established in 2009 as a wholly-owned Government Business Enterprise. NBN Co. was established by the Commonwealth government to design, build and operate a wholesale-only national broadband network (NBN) across Australia to redress various perceived market failures in the area.[37] The government's intention was that around 93% of Australian homes, schools and workplaces would be connected to the network, delivering broadband at fast speeds to users. The roll-out of fibre to the premises network was planned to continue until 2020. NBN Co. had a corporate plan, an independent board and management team, and was to be funded by government equity until it had sufficient cash flows to support private sector debt. In the longer term, the government expected it to be self-funding, and intended to sell down its interest within 5 years of the NBN being fully operational. The government expected NBN Co. to operate in a commercial manner, charging for access to the network (fibre, wireless or satellite) at the point of interconnection. Retail service providers would transport their data from the point of interconnection to the point of presence (the backhaul).

The complainants alleged that NBN Co. was not complying with CN policy in a number of respects. Firstly, it was alleged that NBN Co actively sought business in commercially viable developments, despite the fact that it had been announced by government as a 'provider of last resort'. In these developments its infrastructure and connections were being provided at no cost, an option unavailable to private providers, and said to be a breach of CN principles. Other complaints related to NBN Co.'s projected 7% rate of return; other alleged breaches relating to Ministerial determinations of technical specifications; the nature of its tendering processes (not fair and transparent); its operational standards; and its role in defining the footprint for the NBN.

At the outset, the Australian Government Competitive Neutrality Complaints Office (AGCNCO) assessed NBN Co.'s actual and intended compliance with taxation, debt, regulatory neutrality and commercial rate of return requirements. Some complications arose because NBN Co. was still in its infancy, so some relevant financial data was unavailable. AGCNCO found that complaints about being a 'provider of last resort' depended on the intention of the government when using these words and the complaint was dismissed in these circumstances. Some other issues were found to be operational decisions and not breaches of CN policy. AGCNCO found that some advantages of NBN Co were because of size and not government ownership. Other complaints related to matters which were not part of CN policy. NBN's pricing model for individual goods and services in particular market segments was found not to be in breach of CN policy.

[37] See National Broadband Companies Act 2011.

AGCNCO was, however, unable to determine whether the difference between a commercial rate of return and the 7% projected by NBN Co. was adequately explained by the non-funded community service obligations of NBN Co.. It recommended that the government arrange for an analysis of the required non-commercial benefits and put in place accountable and transparent community service obligation funding. It also recommended that NBN Co. adjust its pricing model by taking into account funding by the government for its CSO obligations, and show how the adjusted pricing model would achieve a commercial rate of return that reflected its risk profile. AGCNCO also agreed with the complainants that the expected timeframe for achieving a commercial rate of return (12 years) represented a potential ex ante breach of CN policy. AGCNCO did not regard the government's commitment of funds to NBN Co. as a shareholder loan as a breach of CN policy, as equity funding of NBN Co. was not subject to the debt neutrality provisions of CN policy. AGCNCO found that Ministerial determinations were not in breach of CN policy if they did not exempt NBN Co. from regulations that applied to its competitors.[38]

In short, while many of the complaints of competitors were not justified, NBN Co. still needed to address a number of its activities to ensure full compliance with CN policy.

3.4 *Measurement of progress in CN reform*

Early analysis of CN policy implementation showed that some governments identified significant business enterprises by size alone, which would have arbitrarily exempted many government business activities with a significant market influence.[39] In reviewing progress at that time the NCC[40] indicated that jurisdictions should identify specific business activities which would be subject to CN. The NCC also expressed concern about the adequacy of some jurisdictional mechanisms for complaints handling, which lacked transparency. The NCC emphasised that the adoption of a CN framework was particularly important in relation to competitive tenders in which an in-house provider participated in the tender process.[41]

An NCC assessment of the progress made by governments in relation to the NCP reforms in 2003 indicated that, with regard to CN, most jurisdictions had committed to full cost attribution for their significant business activities but struggled to deal with some other issues. These included the application of marginal pricing or competitive pricing strategies in the short term. Coverage of the governments' CN policies was generally satisfactory, with

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[38] Australian Government Competitive Neutrality Complaints Office Investigation No 14, 24 November 2011: http://www.pc.gov.au/agcnco/publications/investigation/nbnco. See also: http://www.pc.gov.au/agcnco/publications/investigation/petnet.

[39] National Competition Council, Annual Report 1995-1996, p. 14.

[40] The National Competition Council was the body originally charged with oversight of NCP.

[41] The NCC noted that it would place particular weight in assessing the compliance of a jurisdiction with implementing CN on allegations of non-compliance and how they were dealt with. See National Competition Council, 'Annual Report 1995-6', p. 15: http://ncp.ncc.gov.au/docs/PIAn96-001.pdf.

room for improvement.[42] Slow policy implementation allowed for some industries detracted from the results and complaints handling could be improved.[43]

In a later review of NCP reforms in 2005, the Productivity Commission calculated that selected NCP reforms had boosted Australia's GDP by 2.5%.[44] In its 2005-2006 Annual Report, the last before the formal finalisation of NCP, the NCC stated that progress in relation to CN had been mixed.[45] All states and territories had corporatised major government businesses, and other significant businesses had been exposed to CN principles. CN complaints units had been established. There was, however, scope for improving coverage of competitive neutrality principles and the operation of complaints mechanisms.[46] Both the NCC and the Productivity Commission[47] stated that commitment to better governance was required to ensure NCP reform met its objectives. The Productivity Commission stated that:

> failure to meet this objective has potentially serious consequences given that GTEs have combined assets of more than $174b and generate $55b in revenue annually.[48]

In an important finding, the Productivity Commission noted that the majority of GTEs it monitored had failed to obtain commercial rates of return on their businesses.[49] In 2004-2005, the aggregate profitability of government businesses increased in areas such as electricity, water and urban transport, but declined in railways, forestry and ports.[50]

A particularly interesting issue in relation to CN policy in Australia is that the number of actual complaints about CN policy issues is small when compared to the very substantial areas of business conducted by government bodies. Complaints are also very unevenly dispersed

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[42] National Competition Council (2003), *Assessment of Government Progress in Implementing the National Competition Policy and Related Reforms: Volume 1*, p. 28: http://ncp.ncc.gov.au/docs/2003%20assessment.pdf. New South Wales' coverage was potentially broadest as it had assumed that CN principles would apply unless an individual government business presented a case that costs exceeded benefits. West Australia had not required businesses operated by public hospitals to apply CN Principles.

[43] National Competition Council (2003), 2.13.

[44] Productivity Commission (2005), 'Review of National Competition Policy: Inquiry Report No 33': http://www.pc.gov.au/__data/assets/pdf_file/0016/46033/ncp.pdf, cited in Rod Sims (2013), 'Driving Prosperity through effective competition', Mexico Forum: http://www.accc.gov.au/speech/driving-prosperity-through-effective-competition.

[45] After the completion of NCP, the NCC handed over the consideration of competitive neutrality complaints against Commonwealth government bodies to the Australian Government Competitive Neutrality Complaints Office, housed in the Productivity Commission. See: http://www.pc.gov.au/agcnco/competitive-neutrality.

[46] National Competition Council (2005-2006), 'Annual Report': http://ncp.ncc.gov.au/docs/AR0506-001.pdfat 59.

[47] National Competition Council (2005-2006).

[48] Productivity Commission (2006).

[49] For a discussion of the measurement of rates of return in a competitive neutrality context, see Commonwealth Competitive Neutrality Complaints Office (1998), 'Rate of Return Issues'.

[50] Productivity Commission (2006).

among the Commonwealth, the states and territories.[51] The state of Victoria, for example, has addressed many more complaints than all other jurisdictions. This may be because there are necessarily many variants in the implementation of individual CN policies. It may be because other mechanisms such as corporatisation have achieved good CN outcomes in other jurisdictions or because Victorian businesses are better informed of their ability to access mechanisms for redressing CN policy breaches. Alternatively, it may be that not many businesses overall consider themselves to be disadvantaged when competing with government businesses or recognise that they are so disadvantaged.

Significant steps have been taken in implementing CN policy in Australia by the Australian Government and the states and territories. Continued diligence on CN in Australia should provide additional economic rewards in the more efficient delivery of competitive government services to the benefit of the community as a whole.

3.5 *Australian competition policy review*

Despite the comprehensive competition policy initiatives of the last 20 years, further change is likely. A new Australian government elected in September 2013 has instituted an 'independent "root and branch" review' of Australia's competition law and policy 'in recognition of the fact that the Australian economy has changed markedly since … 1993'.[52] The review is the most comprehensive since the Hilmer Review.[53] It is very wide-ranging, and is based on the following policy objectives:

1.1. no participant in the market should be able to engage in anti-competitive conduct against the public interest within that market and its broader value chain;
1.2. productivity-boosting microeconomic reform should be identified, centred on the realisation of fair, transparent and open competition that drives productivity, stronger real wage growth and higher standards of living;
1.3. government should not be a substitute for the private sector where markets are, or can, function effectively or where contestability can be realised; and
1.4. the need to be mindful of removing wherever possible, the regulatory burden on business when assessing the costs and benefits of competition regulation.[54]

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[51] See Victorian Competition and Efficiency Commission, 'Competitive Neutrality inter-jurisdictional comparison': http://www.vcec.vic.gov.au/CA256EAF001C7B21/WebObj/CNinter-jurisdictionalcomparisonpaper(PDF)/$File/CN%20inter-jurisdictional%20comparison%20paper%20(PDF).pdf.
[52] See 'Competition Policy Review: Terms of Reference': http://competitionpolicyreview.gov.au/terms-of-reference/. These terms of reference were released in March 2014.
[53] The Dawson Review, which reported in 2003, was more concerned with amendment of competition law itself, rather than competition policy. See http://tpareview.treasury.gov.au/content/termsofref.asp for the Dawson Terms of Reference and http://tpareview.treasury.gov.au/content/report.asp for the Report.
[54] See 'Competition Policy Review: Terms of Reference'.

Among its 'key areas of focus', the review will look at 'government involvement in markets through government business enterprises, direct ownership of assets and competitive neutrality policy, with a view to reducing government involvement where there is no longer a clear public interest need. It will consider how well CN policy is working.'

This suggests that there is an appetite for further privatisation of government businesses which would once again reduce the impact of government on competition in the market, reducing the need for CN policy initiatives.

Despite its comprehensive nature the review is to report within 12 months. The outcome of this review is currently unknown. It may recommend a lesser involvement by the government in contestable markets. However, as long as there is government involvement in contestable markets, CN policy, in one form or another, will continue to be an important tool for ensuring a level playing field between government business and private market participants.

The Australian CN experience provides an example of a structured approach with a positive outcome in one jurisdiction. It is a useful example of what might be done to redress government market advantage in other jurisdictions but will not be suitable for every jurisdiction. It was effective for a number of reasons, not least because of the financial incentives for participating states and territories under NCP, but also because of its adoption as part of a comprehensive plan to reform the Australian economy.[55]

4. CN Project Findings

This section of the chapter draws some conclusions about CN in the subject jurisdictions, which as noted previously are all considered to be developing countries and are not current OECD members. The chapters all illuminate the nature of SOEs, their regulation, and on-going reforms to improve efficiency and competitiveness.

The two chapters on China focus on developments in relation to SOEs within the jurisdiction generally and on developments in particular industries. The first chapter by Professor Xu Shiying looks in some detail at the current nature of SOEs in China against the background of its political economy and its constitution. The author describes the administration and operation of SOEs and the history of their reform, and outlines in some detail the types of market advantage and disadvantage which accrue to SOEs in China. She outlines the

[55] See Rennie, Matthew and Fiona Lindsay (2011), 'Competitive Neutrality and State-Owned Enterprises in Australia: Review of Practices and their Relevance for Other Countries', OECD Corporate Governance Working Papers No 4, OECD Publishing: http://vvv.oecd.org/dataoecd/56/58/48510172.pdf, where a number of factors for success are identified by the authors. In the view of this author the financial incentives were a particularly important factor in the overall success of the NCP.

application of the Anti-Monopoly Law to SOEs and its relationship with industry specific regulation. Finally, detailed case studies in two industries, petroleum and cement, illustrate the current position of SOEs in those markets and the steps taken to make these markets more competitive. The author emphasises the continuing nature of SOE reform in China, and suggests that while some progress has been made, it is too early for a comprehensive CN policy. She notes that a structured CN policy may never be entirely appropriate given the nature of the Chinese economy. The second chapter on China by Alberto Gabriele focuses in particular on infrastructure services, looking carefully at the motivations and policy approaches supporting their substantial development and restructuring. The author then focuses on the telecommunications sector, which provides for useful comparison with other studies in the project, particularly Vietnam which the author notes is the only other 'market-socialist socio-economic formation' (MSSEF), and the chapters on telecommunications in Malaysia.

A very detailed chapter on India by Seema Gaur describes the broader issues of public-private competition and the role of the state in the market place as '21st century issues'. The author notes that CN is very important in India because of the 'mixed economy' approach the country has taken to economic development. She details the development of the economy and the role of government in the market from independence in 1956, when SOEs were set up to drive rapid growth in the face of an agrarian economy with a weak industrial base. Liberalisation of the economy in 1991 followed recognition that many public enterprises were a burden rather than an asset for the state. The chapter outlines the types of SOE in India and their contribution to the economy. Continuing structural and corporate governance reforms are also outlined. The author notes that the Competition Act 2002 applies to all bodies whether or not they are government-owned, in contrast to the previous competition law which exempted SOEs. The author gives a number of examples where the Competition Act has been applied to SOEs and notes that a National Competition Policy for India under a broad competition-based framework has been under consideration.
Two chapters on Malaysia provide a detailed analysis of the developments there. Malaysia has no specific policy concerning competitive neutrality, reportedly because 'the government considers that it is not yet an obtainable objective'.[56] Despite this lack of overt commitment to competitive neutrality principles, the government has indicated its commitment to competition through various other actions it has undertaken to restructure various aspects of participation by government businesses in the market.

Chapter Five by Wan Khatina and Saovanee Chan Somchit describes in some detail how Malaysia has undertaken substantial structural reform of SOEs in a country which since colonial times has had a large government involvement in markets. They explain how Malaysia currently regulates SOEs' activities in the absence of an explicit CN policy framework.

[56] OECD (2014), 'Competitive neutrality: National Practices in Partner and Accession Countries', p. 12.

Following independence, the government in Malaysia took a significant role in managing natural resources, and introduced the important National Economic Policy, an economic programme of affirmative action for Bumiputeras, the indigenous groups of Malaysia, after the race riots in 1969. A privatisation programme followed in 1983, with a number of important SOEs being privatised (described as 'privatised' although the government may still own majority shares in these entities). A more comprehensive privatisation process followed, faced a major setback in the Asian Financial Crisis, and accelerated afterward. A range of SOEs still exist, and the authors note that the government prefers to maintain a level of ownership rather than to completely sell the SOEs it is reforming. The authors describe the direct and indirect government ownership of these bodies, some of which are extremely successful. They note that CN can be substantially achieved by corporatisation and privatisation of SOEs, processes 'actively undertaken' by the Malaysian government. As for advantages and disadvantages, the government partially subsidises universal service obligations to underserved communities. In some industries all market players are required to contribute to a universal service fund administered by the sector regulator, but have access to the fund on a full reimbursement basis. SOEs in Malaysia, however, make substantial contributions to tax revenue. The chapter focuses in particular on the commercial banking sector, where market players are state- and non-state owned, local and foreign. Listed SOEs are subject to regular corporate regulation. All SOEs are subject to specific public accountability measures and performance targets. The authors rightly highlight that the challenge for the government in relation to SOE regulation is to find the right balance between promoting efficient markets and managing political sensitivities. They conclude that a CN framework may not be appropriate in the current economic and development environment but that such a framework may be possible in future.

The second chapter on Malaysia by May Fong Cheong and Pushpa Nair focuses more particularly and in detail on steps taken to liberalise and foster competition in the telecommunications industry. The incumbent Telekom Malaysia Berhad is a government-linked company and the government plays an important role in the industry. It was also the first industry with a competition law framework in the Communications and Multimedia Act 1999 (CMA), which replaced earlier industry regulation. The chapter details the main areas of regulation contained in the CMA to assess how the regulation responds to CN concept. In that respect, no real distinctions are drawn in the application of the regulation between SOEs and other competitors.[57] Case studies of telecommunications issues look at High Speed Broadband, Spectrum and Netbook issues and assess outcomes. Several policy tools impacting on CN in Malaysia are considered in more depth: institutional reforms; reducing the role of government in business; corporate governance; and public procurement. The authors conclude that there are still outstanding issues of transparency and accountability and that continuing developments in the commercial landscape with government divestitures

[57] Telecommunications issues are covered by the CMA and are exempt from the Competition Act; however, the competition provisions in both are similar.

of GLCs and corporate governance will indicate the true extent of the government's commitment to CN.

Importantly, both chapters on Malaysia note that the new Competition Act 2010, in force since January 2012, is an important factor in its CN framework, applying as it does to all commercial activities including federal or state departments, or other bodies or agencies carrying out commercial activities.

The chapter on Vietnam, contributed by Nguyen Anh Tuan, confirms the crucial role that SOEs continue to play in the Vietnamese economy, particularly in 'essential industries', despite some liberalisation. SOEs are the accepted norm and the author notes that while SOEs played an important part in Vietnam's growth in the 1990s, many are not subject to competition but governed by administrative decisions, leaving them inefficient and without appropriate scale. Private sector enterprises, by way of contrast, form the most dynamic part of the economy, despite that fact that they are generally small- to medium-sized enterprises. The author in fact demonstrates the legislative and administrative measures which the authorities have used to create advantages for SOEs over private competitors in some industries, using the telecommunications industry as a case study. A competition law was passed in 2004, and it purports to apply to all organisations conducting business, which means that SOEs fall within its scope. Despite this the author queries whether this law will be used as a sword or a shield to protect SOEs from foreign and domestic competition.

Finally, Graham Mott and Wan Khatina review CN in the broader international sense, focusing on attempts by some jurisdictions to deal with SOEs and their conduct outside their own jurisdictions, particularly in cross-border investment activities. The concerns of developed countries in this respect relate to the relationships that these SOEs may have with their own governments, particularly in relation to investments based on non-commercial considerations. This interesting and useful chapter details attempts to discipline SOEs at the international level via international legal instruments, and the use of SOE-related provisions in preferential free trade agreements. The chapter discusses a wide range of initiatives and draws some useful conclusions on outstanding issues which need to be considered, finally emphasising the importance of addressing the issue comprehensively and effectively under the proposed TPP Agreement which may eventually become an APEC-wide PTA.

The following broad conclusions may be drawn from the various contributions. The subject jurisdictions are at various stages of development and structural reform but all are characterised as developing nations, which means that development in itself is a priority. All recognise the impact which competition has on the efficiency of markets. All have competition laws. All have reformed their government business enterprises to some extent, including by corporatisation, and by heightened obligations for governance, transparency and ccountability. Some have privatised a range of government businesses. This appears to be very much a continuing process in all of the jurisdictions surveyed.

China and Vietnam envisage a continuing significant role for government businesses in their markets and are strongly influenced in this approach by their ideological perspectives. Both jurisdictions focus heavily on SOEs within industries that they consider to be strategic and this appears unlikely to change in the short- to medium-term. Malaysia also envisages a continuing role for government in its markets but this appears to be more from a developmental perspective than any ideological commitment to maintaining SOEs in the hands of the state. None of these three jurisdictions has overtly adopted a CN policy of any kind,[58] and none appears to have transparently given it detailed consideration. However, this is not to criticise their SOE reform, which is on-going and, particularly in the cases of China and Malaysia, very substantial.

India appears to be the most receptive to the implementation of full CN principles, most probably because of the recognition of the major structural and competitive inadequacies of its SOEs, which were originally adopted for development reasons. India has very substantially reformed the governance and accountability of its SOEs and is considering the adoption of an NCP, despite the acknowledged significant political difficulties facing such an approach.

Finally, consideration of CN issues on the broader international scale is becoming more important given the growth of SOEs and their growing involvement in international trade. Whether these issues can be resolved by agreement and whether this will become a bigger issue internationally remains to be seen.

The issue of CN policy will likely come under further scrutiny in each of the jurisdictions considered as they continue to reform and develop their SOEs. Positive competitive outcomes arising from on-going reform should push governments to further reform. Even without the implementation of a comprehensive CN policy, however, governments should regularly, and at the very least, consider the impact of policy decisions, regulation, SOE conduct and SOE advantage on the market if they truly wish to foster competition within their jurisdictions.

[58] Although it has been recognised as an issue in China and in Malaysia. See OECD (2013), 'Working Party on State Ownership and Privatisation Practices, Competitive Neutrality: National Practices in Partner and Accession Countries', pp. 11-12.

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Financial Management and Accountability Act 1997
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Competitive Neutrality of SOEs in China

Xu Shiying

Foreword

Before discussing the competitive neutrality issues of SOEs in China, there are several special factors that should be considered as background.

Firstly, the special provisions provided in the Constitution of the People's Republic of China in relation to 'socialist public ownership'[59] and the 'state-owned economy'[60] are important factors in considering the status of competitive neutrality policy in China. China's Anti-Monopoly Law (AML) faces a double dilemma when dealing with state-owned enterprises (SOEs). On the one hand, AML cannot conflict with the constitution, which completely protects SOEs as the leading force of the national economy. On the other hand, AML is applicable to all monopolistic conduct, including that of SOEs.

Secondly, China is transitioning towards establishing a market-oriented economic system. There are still many structural problems and obstacles that impact on the sustainable development of the economy. Reforms relating to SOEs, natural monopoly industries and government regulation are still being explored and developed.

Finally, in recent times in China, different forms of monopoly such as market monopolies, natural monopolies and administrative monopolies have intertwined, and most are related to SOEs. Competition issues in relation to SOEs are often related to anti-competitive actions of the government that result from relevant economic policies. This makes the enforcement of competition laws more difficult.

[59] Article 6 of the Constitution states that the basis of the socialist economic system of the People's Republic of China is socialist public ownership. In the primary stage of socialism, the state upholds the basic economic system in which public ownership is dominant and diverse forms of ownership develop side by side.
[60] Article 7 of the Constitution provides that the state-owned economy, namely, the socialist economy owned by the people, is the leading force in the national economy. The state ensures the consolidation and growth of the state-owned economy.

1. SOEs in China

1.1 *The concept and nature of SOEs*

Over time, the concept of SOE has changed in China. Before economic reform began in 1978, all enterprises were 'state-run enterprises' (SREs), that is, the state not only had ownership but also operation (management) rights of the enterprises. In the process of reform, the operation rights of SREs were separated from the ownership rights. The operation of these enterprises was gradually transferred from the state to individuals, while the state continued to maintain ownership of state enterprises. Some state enterprises even started to be managed by private legal persons under different forms of contract, tenancy, joint venture or corporations. As a result, SREs lost their 'state-run' nature and were replaced by the notion of Enterprises Owned by the Whole People (EOWP), which was primarily defined in *General Principles of the Civil Law of the People's Republic of China* (hereafter referred to as the General Principles of the Civil Law) adopted in 1986. This conversion represented not only the separation of state ownership and operation rights in SOEs, but also the separation of government roles of capital owner and administrator. With the deepening of reform, the concept of SOE appeared. Although there is no doubt that the state owns the 'controlling right over SOEs', there is still debate about the concept of SOE. In these debates, the most widespread definition is that SOEs are legal persons over which the state has control through ownership, including direct and indirect investment. According to this general definition, SOEs can be defined as follows:

- **The state is able to exert influence on SOEs through capital controls**: There are direct or indirect capital connections between the state and SOEs, and such connections enable the state to exert controlling influence over SOEs. In fact, most capital connections in China are indirect, which means SOEs are controlled by State-owned Asset Supervision and Administration Commissions (SASACs), both at central and local levels.

- **SOEs: special legal persons**: It is the final goal of SOE reform to make SOEs formal legal persons. To realise this objective, SOEs need to be given the independent right to own property and to assume liability, in order that they have the goal of making profits. Of course, there still exist many SOEs without legal personality, such as partnership firms associated with enterprises in the private sector and public institutions. Although there is a trend towards corporatisation in SOE reforms, SOEs without legal personality still exist.

There are two other related concepts that should be distinguished from the concept of SOE: state-owned economy and state-owned capital. State-owned capital is national wealth which is liquid and transferable. State-owned economy refers to an economic form in which the state sets up enterprises, through direct or indirect investment, to achieve goals such as macroeconomic regulation and public interests. The relationship between these three is that

SOEs are the means of operating and managing state-owned assets to strengthen the state-owned economy.

1.2 *Types of SOE*

Given the different means of state investment and the proportions of state-owned shares in SOEs,[61] SOEs in China can be categorised into four types: wholly state-owned enterprises, wholly state-owned companies, state-controlled enterprises and non-controlling state-owned enterprises. Each of these is discussed below.

- **Wholly state-owned enterprises (WSOEs)**

WSOEs refer to those enterprises in which the state is the sole investor, and owns the entirety of the assets. WSOEs are directly subject to government control and are not required to implement a corporate system. The directors and managers of WSOEs are appointed by governments at all levels. Their property is operated and managed with the authorisation of the state, in accordance with the principle of the separation of ownership and managerial authority. It should be emphasised here that, until the promulgation of the *Decision of the Standing Committee of the National People's Congress on Amending Some Laws* in 2009, WSOEs were required to adopt contract or leasing forms to operate enterprises.[62] Typical WSOEs include China Mobile Communications Co., China Tietong Telecom Co. and China Electronics Co. and some enterprises in the railway, airline and gas industries.

- **Wholly state-owned companies (WSOCs)**

WSOCs are different from WSOEs. While the state is the sole investor, they are legally registered as companies with limited liability. Moreover, WSOCs adopt the shareholding system of managerial responsibility. The State-owned Asset Supervision and Administration Commissions (SASACs), authorised by the State Council or local governments, are in charge of the investment functions of WSOCs. As state-funded limited liability companies, the sole investors in WSOCs are state agencies authorised by governments in the form of state-owned assets. The state assumes limited liability to the extent of its capital contributions.

State-owned assets cannot be withdrawn as long as the company exists, but may be

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[61] According to Article 5 of the Law of the People’s Republic of China on State-owned Assets of Enterprises, the term ‘state-invested enterprise’ refers to a wholly state-owned enterprise or company where the state is the sole investor, or a company in which the state has a stake, whether controlling or non-controlling.

[62] According to Paragraph 4 of Article 2 of the Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People, the enterprise may, in accordance with the decision of the competent department of the government, adopt contract, leasing or other systems of managerial responsibility. In the Decision of the Standing Committee of the National People's Congress on Amending Some Laws enacted in 2009, the above provision was abolished. See: http://www.gov.cn/flfg/2009-08/27/content_1403326.htm.

transferred to other enterprises or individuals, including enterprises in private sectors, in accordance with laws and administrative regulations.[63]

- **State-owned holding companies (SOHCs)**

SOHCs are SOEs in which the state owns more controlling voting stock than other investors (not necessarily above 50%). These bodies are regulated by specific legislation and incorporated with very strict authorisation. In general, there are two types of SOHCs: pure state-owned holding companies and mixed state-owned holding companies. The former exist solely for the purpose of exercising control over other enterprises and are not directly engaged in business. The latter engages in production and business operations, and is prohibited from investing more than 50% of its registered capital in the total capital invested in its subsidiaries. In China, SASACs[64] are typically pure SOHCs, as they do not engage in business operations but only exercise property and stock rights, while companies like China CITIC Group and Ping An Insurance Corporation of China are mixed SOHCs. They both engage in equity and business operations in businesses such as securities, insurance and even real estate.

- **State-owned non-controlling companies (SONCs)**

SONCs are not really SOEs as the state, as a common shareholder, has no controlling power over other investors in the companies. Compared to other types of SOEs, they do not strictly have social welfare objectives, yet the existence of such companies is to strengthen the state-owned economy. It should be emphasised that they have similarities with general non-SOEs, since most of these companies operate in industrial sectors in competition with other enterprises. Depending upon the extent to which SOEs are involved in competition,[65] they can also be categorised into three types: public welfare SOEs, monopolistic SOEs and competitive SOEs.

- **Public Welfare SOEs**

Public welfare SOEs are enterprises that exist for the purpose of providing public goods and public services. They enjoy government subsidies and generally do not adopt market principles nor participate in market competition. These enterprises mainly lie in industries such as water conservation, power supply, environmental sanitation and infrastructure construction.

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[63] According to Article 53 of the Law of the People's Republic of China on the State-owned Assets of Enterprises, the transfer of state-owned assets shall be decided by the body performing function of contributor. If a body performing the function of contributor decides to transfer the state-owned assets in their entirety, or partially transfer state-owned assets such that it causes the state to lose the controlling position over the enterprise, it shall report such a decision to the corresponding people's government for approval. The body here refers to SASACs.

[64] The State-owned Asset Supervision and Administration Commissions.

[65] Such a classification standard has been adopted in Beijing and Zhuhai. See Hongjun, Zhao (2009), 'An Investigation on the Classification and Supervision of SOEs in Beijing', *Journal of Beijing Administrative College* 6; and Zhuhai Municipal People's Government (2005), 'A Notice on the Classification and Supervision of SOEs at the Zhuhai Municipal Level', available at: http://new.zhda.gov.cn/dagb/dagb0522.htm.

- **Monopolistic SOEs**

Monopolistic SOEs are enterprises that enjoy monopoly rights authorised by governments by creating barriers to deter other enterprises from entering their markets. Such barriers include high standards of registered capital, technology and risk management ability. In fact, most monopolistic SOEs exist in natural monopoly industries and resource-based industries in China. Their monopolistic status slows down the efficiency of these industries, and China is making efforts to introduce competition in these industries. China has already made some initial progress in this direction. For example, the divestiture of State Grid Co. and the reconstruction of telecommunication industry have been completed.

- **Competitive SOEs**

Competitive SOEs refer to enterprises owned by the state that compete with other enterprises. These enterprises mainly lie in the manufacturing, commercial and service industries, where private capital is abundant and there are no strict administrative barriers to enter and withdraw from the market.

1.3 *The administration and operation of SOEs*

1.3.1 The administration authority for SOEs: The State-owned Assets Supervision and Administration Commissions (SASACs)

SASACs are government agencies authorised by the State Council or local governments to act as capital investors and to supervise state-owned assets in SOEs. Therefore, the role of SASACs is twofold. On the one hand, it represents investment in state-owned assets and exercises the rights of ownership under the authorisation of the state; on the other hand it is the supervisor of the assets. It performs the following four functions:

- it drafts laws and regulations on the supervision and administration of state-owned assets;
- it designs medium- and long-term plans so as to optimise the allocation of state-owned assets;
- it defines property rights, assesses and accounts for state-owned assets, and settles disputes related to SOEs’ property rights;
- it monitors whether SOEs have made all efforts to preserve and increase the value of the assets, and promotes the reform and reorganisation of SOEs.

SASACs can also sell state-owned assets when individual enterprises are not viable. They may also invest in other areas of business when the economic situation changes.

1.3.2 The operation of SOEs

- **Public welfare SOEs and monopolistic SOEs**

Public welfare SOEs and monopolistic SOEs mainly aim to provide public goods and services to improve social welfare. Thus, these two kinds of enterprises are mostly concentrated in fields such as military, currency minting, infrastructure construction industries which are related to national security and social welfare industries like medical care, environmental engineering and energy. Nevertheless, there are differences between public welfare SOEs and monopolistic SOEs. Public welfare SOEs are more like public institutions, which are totally funded by governments and exist for the sole purpose of promoting public welfares. Monopolistic SOEs, meanwhile, also have the objective of making profits and can be WSOEs, WSOCs or SOHCs. Public welfare SOEs are not required to implement the corporate system. There is no need for them to set up a Board of Directors as governments make all decisions. Monopolistic SOEs, however, are generally required to operate under the corporate system.

- **Competitive SOEs**

Competitive SOEs are profit-oriented enterprises that maintain and increase state-owned property by pursuing profit. Almost all competitive SOEs compete with private enterprises, where they both share the purpose of making profits. However, it is inevitable that competitive SOEs have advantages over private enterprises because of their ‘state-owned’ nature, such as advantages of government guarantees, concessionary financing and lower operation costs. In the 1990s, some scholars and experts suggested that SOEs should bow out of competitive industries so as to better improve competition. In fact, the state has realised this and has made strenuous attempts in SOE reforms to withdraw from competitive fields. It should be noted that this will take a long time as China is still in a transitional period.

2. History of SOE Reform in China

2.1 *Decentralising power to SOEs and allowing them to share profits (1978-1986)*

There were multiple reforms of SOEs between 1978 and 1986. Under the central planning-oriented economic system, the primary character of these reforms was the decentralisation of power from the state. SOEs were also allowed to partly share the profits they earned. During this period, a series of policies and legal documents were enacted by the State Council and some ministries, such as the *Decision of Central Government on the Reform of Economic System*. These documents preliminarily readjusted the relationship between SOEs and governments, and encouraged the conversion of the production and operation mechanism of these enterprises.

The reform to decentralise power to SOEs and allow them to share profits was established to harden budget constraints, stimulate motivation and decentralise power to enterprises. This reform included expanding the operational autonomy of enterprises, paying taxes instead of turning over all profits to the government and leasing systems of managerial responsibility.

- **Expanding enterprises' operational autonomy**

Initially, the State Economic Commission and the Ministry of Finance promulgated five normative documents to expand the rights of enterprises in 1979, including the *Notice of Expanding the Operational Autonomy of State Industrial Enterprise*, and the *Provisions on the Implementation of Retained Profit of State Enterprises*. The main contents of these normative documents are as follows:

- Enterprises have the right to formulate a supplementary scheme in accordance with market demand, on the premise that the plan set down by the state has been completed. Additionally, the products under the supplementary scheme shall be sold at a state-fixed price.
- Enterprises have the right to retain profits, to establish and operate a production development fund, a collectively-owned welfare fund and a staff and workers' welfare fund.
- The depreciation rate of fixed assets and the ratio of profits retained by enterprises are gradually increased.
- Enterprises have the right to apply to the related central and local government departments to export their own products. After obtaining their approval, enterprises can retain foreign exchange based on relevant rules.

- **Paying taxes instead of turning over profits to the state**

In 1983, the State Council approved the *Trial Measures on Paying Taxes Instead of Turning Over Profits to the State*, providing two steps in the process of this reform. The first step provided that enterprise income tax would be levied at a fixed rate on SOEs, while the rate of profits after tax turned over to the state would be determined after negotiations. The second step implemented single taxation, whereby a progressive rate was applicable to income tax instead of a proportional rate, abolished the requirement for SOEs to turn over profits, and simultaneously levied resource tax, asset tax and regulation tax.

2.2 *Separation of ownership and management (1986-1992)*

2.2.1 Contract system of managerial responsibility

The contract system of managerial responsibility is a type of operation and management system which is based on socialist public ownership. The principle of the system is the separation of ownership and management. According to the system, the relationship of responsibility, management rights and profits between the owner of the enterprise and the relevant government body is clarified by a signed contract. To illustrate the system, its fundamental layout can be summarised as consisting of 'two guarantees and one connection'. The enterprise guarantees to complete the tax and profit target stipulated by the contract; the enterprise guarantees to complete the technical transformation task using retained capital from their production profits; and the decision on total wages should be connected with the benefits of enterprises. The contract system was implemented differently in different types of enterprises to accommodate their diverse industry nature, enterprise scale and technical features. To implement the contract system of managerial responsibility, a contract should be signed by the operator of the enterprise and the relevant government body. Under this contract, the relevant government department is the party issuing the contract while the owner of enterprise is the contractor. Additionally, the contract should continue for no less than three years.

The policy on pushing forward multiple forms of contract was proposed by the State Council in 1986, and became widespread after 1987. Until 1991, 98% of large and medium-sized SOEs adopted diverse contract forms to some extent. As a result, enterprises have become more active since that time. To illustrate, during the period from 1987 to 1992, the average growth of sales revenue, and the tax and profits of SOEs turned over to the state increased by 21% and 12% per annum respectively. The successful establishment of multiple forms of operation – mainly the contract system – launched the separation of ownership and management, and the separation of governmental functions and enterprise management. Obviously, the adjustment of the relationship between government bodies and enterprises was not limited to the profit distribution relationship. Actually, enterprises obtained some property rights. Consequently, the role of SOEs was transformed from being an affiliate of an administrative organisation to a producer and supplier of commodities, indicating the transition and deepening of the reform of SOEs from the level of management to ownership.

However, the contract system of managerial responsibility did not change the traditional corporation system completely. The relationship of affiliation between enterprises and administration still exists both deeply and broadly. In other words, it determines the extent of governmental interference. On the other hand, the government had to decentralise its power when facing the downturn in the national economy. Therefore, the contract system reform could only stagger forward in a cycle of 'decentralising-centralising powers'.

2.2.2 Promulgation of the *Law on Industrial Enterprises Owned by the Whole People of the People's Republic of China*

In China, the *Law on Industrial Enterprises Owned by the Whole People of the People's Republic of China* (hereafter the Industry Enterprises Law) was a landmark in the process of decentralising power and distributing profits. It was enacted on 13 April 1988 and implemented on 1 August 1988. The key purpose of the Industry Enterprises Law was to establish and realise the separation of ownership and managerial authority. In other words, the property of the enterprises was owned by the people (the state), and operated by the enterprise with the authorisation of the state. Accordingly, different actors, including the enterprise, manager, labour union and government carry out their respective duties. In addition to the separation of ownership and management, other important principles were also established within this law, such as the separation of party and government bodies, the separation of governmental functions and enterprise management. The Industry Enterprises Law greatly promoted the reform of SOEs in China. Several ambiguous provisions, however, raised enforcement problems. For example, the extent of enterprises' civil liability and the coordination of the relationship between managers and employee associations were both unclear.

2.2.3 State-owned assets operation obligation system

In view of the above problems of decentralising powers and distributing profits, a new reform approach was explored. Based on previous experiences and lessons, a state-owned assets operation obligation system was implemented to restructure the macroeconomic foundations of China. Under the state-owned assets operation obligation system, the right to operate an enterprise was authorised by signing an assets management obligation document. According to the document, the operator was responsible for the benefits and workers of enterprises, but also for the preservation and increment of state-owned assets during the operation. The process was divided into two steps:

- The representatives of the owner and operators of SOEs would sign an assets management obligation document. In the document, their responsibilities were confirmed. For example, the owner defined the operator's responsibility to the state-owned assets by ratifying the target indicators for the increment of assets, production increment, gross output and profit margin of assets.
- The second step was to assess performance based on the identified indicators and to decide the corresponding reward or punishment.

The primary objectives of the state-owned assets operation obligation system involved:

- The diversification of ownership forms and economic sectors in which the existence of private capitalistic economy would, within a certain range, be allowed.
- A new separation of ownership and management, so that SOEs would be real producers and managers, rather than administrative affiliations.

Nevertheless, compared to the other reforms, the state-owned assets operation obligation system distributed fewer interests and stipulated stricter obligations for SOEs. Furthermore, its enforcement required the superintendents of administrative departments to possess a higher level of understanding of operational techniques. For those reasons many enterprises decided not to take part in the state-owned assets operation obligation system, given the right to freely choose the form of SOE reform. Therefore, this reform was not very widely used.

2.2.4 Promulgation of the *General Principles of the Civil Law*

The *General Principles of the Civil Law of the People's Republic of China* (hereafter the General Principles of the Civil Law) was enacted in April 1987 and implemented from January 1988. It defined the property rights of SOEs. Article 48[66] and Article 82[67] of the Law stipulated that SOEs do not enjoy independent corporation property rights, but enjoy management rights over property authorised by the state. Under this law, the relationship between government bodies and enterprises was like that between 'father and son' and so was hard to break. Enterprises did not possess freedom of management, and the government had significant influence. Thus, the operative autonomy of SOEs was adversely affected.

2.2.5 Debate

The separation between ownership and management of SOEs is controversial. Critics think the expected outcome is often not achieved. According to this view, although the separation model (especially the contract system of managerial responsibility) apparently enhanced SOEs' efficiency in the short-term, this kind of separation actually results in the unfettered exercise of the right of management autonomy, without restraint being exercised by state ownership outside and the self-discipline mechanism operating inside SOEs. Thus, they argue that this kind of separation led to the rights of management overriding the power of ownership, subsequently increasing the privatisation of interests and adding to the socialisation of SOEs' costs.

Since the activity of operators did not increase and the cost of operation was high, the contract system was abrogated nationwide. At that time, the property right system of enterprise did not involve the reform of SOEs. The reform creating an innovation mechanism had not started and consequently SOE reform was only gradual, exploratory and shallow.

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[66] According to Article 48, an enterprise owned by the people, as a legal person, shall bear civil liability for the property that the state authorises it to manage. An enterprise under collective ownership, as a legal person, shall bear civil liability for the property it owns. A Chinese-foreign equity joint venture, Chinese-foreign contractual joint venture or foreign-capital enterprise, as legal persons, shall bear civil liability for the property it owns, except as stipulated otherwise by law.

[67] According to article 82, enterprises owned by the people shall lawfully enjoy the rights of management over property that the state has authorised them to manage and operate, and the rights shall be protected by law.

2.3 *Corporate shareholding reform of SOEs, and the establishment of a modern enterprise system (1992-2002)*

2.3.1 Initial exploration of corporate restructuring

Corporate shareholding reform started with employees purchasing stock options in SOEs. For instance, in 1984, a share-holding company, Beijing Tianqiao Department Store Co., Ltd, was established and the stocks of Shanghai Feilo Acoustics Co., Ltd were offered to the public. These symbolic events marked the beginning of the pilot of the shareholding system. In 1992, Mr. Deng Xiaoping encouraged corporate shareholding reform in his Southern Tour speech. Subsequently, to push forward the pilot reform of the shareholding system more actively, in May 1992 the State Commission for Restructuring the Economic System and other government departments promulgated the *Measures for Experiment on Joint-stock Enterprise*. At the end of 1992, there were 92 listed companies within 3,700 pilot enterprises. Moreover, the enactment of the *Company Law of the People's Republic of China* (hereafter the Company Law) in 1993 signified the reform of the shareholding system of SOEs along an institutionalised and standardised path. In November 1993, the *Decision on Some Issues Concerning the Establishing of the Socialist Market Economy* was made at the Third Session of the Fourteenth Central Committee of the CPC, the first CPC document to expressly and clearly indicate the establishment of a modern enterprise system. The prime characteristics of a modern enterprise system were clearly established: an ownership structure, well-defined power and responsibilities, a separation of operation rights from ownership rights, and management practices in line with market rules.

2.3.2 Strategic restructuring of SOEs

In light of the weakness of the contract system of managerial responsibility, the reform failed to promote the development of SOEs in the market economy and there was some asset erosion. To rescue SOEs, at the First Session of the Fifteenth Central Committee of the CPC, a three-year recovery reform was proposed.[68] Under this proposal, between 1998 and 2000 the majority of large or medium-sized unprofitable SOEs escaped their difficulties assisted by the adoption of a modern enterprise system. Subsequently, at the Fourth Session of the Fifteenth Central Committee of the CPC, the *Decision Concerning Several Vital Problems on State-owned Enterprise Reform* was made to continue promoting the reform of SOEs, establishing that 'we should encourage enterprise mergers, standardise bankruptcy procedures, divert laid-off workers, increase efficiency by downsizing staff and encourage re-employment projects'. Within this period, the principles of 'managing successfully large enterprises while invigorating small ones', 'adhering to the principles of developing what should be developed, withdrawing what should be withdrawn, doing what should be done while leaving others

[68] By the end of 2000, this goal was fundamentally realised. At the end of 1997, there were 16,874 state-owned and state-controlling large or medium-sized enterprises, among which 6,599 (39.1%) were making losses; by 2000, the number of loss-making enterprises had reduced to 1800.

alone', and 'strategic restructuring of SOEs', guided the reform of SOEs. Innovation was accelerated. By the end of 2000, the majority of large- or medium-sized SOEs had been reformed, and a batch of disadvantaged SOEs and most small-sized SOEs had exited the market or become non-public ownership enterprises, through merger or acquisition, bankruptcy and public sale.

Accordingly, during this phase, a group of mixed ownership enterprises emerged, with a diversity of equities and stockholders, accelerating institutional innovation. After more than twenty years of exploration and practice, the strategic guideline of the reform of SOEs in China was achieved. It established a modern corporate system and readjusted the industrial structure of the state economy. At this point the reform of SOEs in China entered into a new era of strategic readjustment.

2.4 *Establishing and improving the management system for state-owned assets (2003-2011)*

In November 2002, the establishment of a management system for state-owned assets was proposed at the 16th Party Congress of the CPC, indicating the start of the capitalisation of management. Under this system, state-owned assets are owned by the state. Central and local governments perform the duties and responsibilities of the capital contributor at the relevant levels, realising the unification of rights, obligations and responsibilities, and administering assets, personnel and affairs. In accordance with the spirit of deepening the management system of state-owned assets established at the 16th Party Congress of the CPC and the Second Plenary Session of the 16th CPC Central Committee, the important principle of this reform can be described as 'three separations, three unifications and three combinations'.[69]

2.4.1 The State-owned Assets Supervision and Administration Commission (SASAC)

Authorised by the State Council, the State-owned Assets Supervision and Administration Commission (SASAC) was established in March 2003, performing the duties and responsibilities of the capital contributor on behalf of the state. At the Third Plenary Session of the 16th CPC Central Committee, it was proposed that SASAC deepen the separation of

[69] Specifically:
- The separation of governmental functions from enterprise management; meaning the State Council empowers SASAC to exercise the responsibilities as the investor on behalf of the state, but not to manage the SOE directly.
- The separation of governmental functions from asset management functions; meaning the separation of the social and public management function of the governments from their function as contributors of state-owned assets.
- The separation of ownership from management; meaning the government should exclude itself from the operational autonomy of enterprises.
- During supervision and administration of state-owned assets, rights shall be associated with obligations and responsibilities, and the administration of assets shall be combined with the administration of personnel and affairs.

public administrative functions and responsibilities of state-owned assets. Consequently, SASAC is responsible for supervision to ensure the preservation and growth of state-owned assets, to prevent the loss of state-owned assets, to establish a state-owned capital operation budget system and an enterprise performance assessment system. In June 2004, state-owned assets supervision and administration agencies were established by local governments nationwide. By 2007, the establishment of state-owned asset supervision and administration agencies at the level of a prefecture or city and the organisation of this system were fundamentally accomplished. In accordance with the *Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises*, SASAC promulgated sixteen regulations and more than forty normative documents, stipulating the restructuring of enterprises, transfer of property rights, assessment of assets, examination of performance and supervision of finance. Moreover, more than one thousand local regulations and rules were enacted. Therefore, the legal system of state-owned asset supervision and administration was fundamentally established.

2.4.2 The board of directors system

Pilot construction of a board of directors system began in 2004. At this time, some wholly state-owned enterprises transformed to wholly state-owned companies. A wholly state-owned company was required to establish a board of directors, which would be responsible for hiring or dismissing the company's manager. However, problems still existed. For example, a board of directors may not have the power to hire or dismiss the general manager (GM), while the outside directors are often retired senior leaders of SOEs. For these reasons, the second phase of construction emphasised the following points:

- Members of the board of directors shall be nominated by SASAC.
- To ensure diversity of membership of the board of directors, external directors from different sources, independent directors and representatives of employees shall be introduced onto the board of directors. In addition, open recruitment could also be undertaken.
- The authority of the board of directors shall be enhanced, for example, by giving it the authority to hire or dismiss the general manager and to take decisions on major matters.

2.4.3 Amendment of Company Law

To improve the laws on companies, the Company Law was revised in 2005, leading to a further transition in the reform of SOEs. At that stage, the primary character of the reform was promoting standardisation, deepening the reform of the state-owned asset management system, improving the modern enterprise system, and promoting corporate and shareholding system reform. After entering the new century, both large-scale SOEs and those at the central level accelerated the process of market-oriented reform and gradually become the most important part of SOE reform as whole. In particular, enterprises in the electricity, telecom, civil aviation and oil and petroleum industries further deepened reform and reorganisation, accelerating the establishment of the modern enterprises system. According to the Eleventh Five-year Plan Compendium and Government Work Report (2006), promoting shareholding system reform in large SOEs was the next step forward.

2.4.4 Securitisation reform of state-owned assets

Securitisation of state-owned assets is a special assets transaction model. It refers to selling assets that lack liquidity to a special purpose vehicle (SPV). Then, investors in the financial markets purchase these assets, in the form of a security, and make profits. The purpose of securitisation is to separate and reorganise the profits and risks of state-owned assets. After the reform, the credit of these assets improved. The reorganised state-owned assets turned into freely-circulated securities, guaranteed by cash flows arising from the operation of the assets, and sold to investors in the financial markets.

The first pilot banks in the securitisation of state-owned assets were China Development Bank and China Construction Bank. The second pilot plan began in 2007, and the pilot objects were Shanghai Pudong Development Bank, Industrial and Commercial Bank of China, Industrial Bank, China Zheshang Bank and GMAC-SAIC Automotive Finance Company. However, when the second pilot plan finished, the global financial crisis occurred. For this reason, the progress of securitisation of assets was stopped.

After the credit crisis in 2009, the regulatory department enacted hard constraints in relation to capital adequacy ratio, and stipulated that credit be tightened up. It therefore required the expansion or resumption of the securitisation of state-owned assets. So far, state-owned asset supervision and administration agencies in Shanghai, Zhejiang, Henan and Anhui have promulgated documents setting out targets for securitising state-owned assets and integrating local state-owned assets. Shanghai, for example, set a securitisation target rate for state-owned assets of 35% for 2011.

During the last five years, the proportion of listed SOEs directly under the central government has increased by a large degree. The coverage rate of the corporation system reform and shareholding system reform among SOEs directly under the central government and their subsidiaries rose from 40% in 2005 to 70% in 2010. Furthermore, the reorganisation of SOEs under local governments is also being carried out. On 2 February 2011, an asset injection plan was drafted by Shanghai Construction Group. Afterwards, the reorganisation of Beijing local SOEs was also accelerated.

The securitisation of state-owned assets contributes to the improvement of SOE governance structures, the reorganisation of state-owned assets, and the optimisation of the industrial structure of the state economy, which are the long term objectives promoted by central and local governments, as well as the focus of the SOE reform.

2.5 *The latest progress in SOE reform*

In recent years, the increase in the state-owned economy's market share, along with the diminishing of the private enterprises' market share, has caused extensive concern. Although a vast majority of competitive areas had been opened to the private economy, the 'glass door' phenomenon – where access theoretically exists but practically does not – was still a serious matter. This phenomenon began to change after the Eighteenth National Congress of the Communist Party of China.

The Report to the Eighteenth National Congress of the Communist Party of China on 8 November 2012 pointed out that, '[t]he underlying issue we face in economic structural reform is how to strike a balance between the role of the government and that of the market, and we should follow more closely the rules of the market and better play the role of the government'. It also indicated that, on the one hand:

> we should unwaveringly consolidate and develop the public sector of the economy; allow public ownership to take diverse forms; deepen reform of state-owned enterprises; improve the mechanisms for managing all types of state assets; and invest more of state capital in major industries and key fields that comprise the lifeline of the economy and are vital to national security. We should thus steadily enhance the vitality of the state-owned sector of the economy and its capacity to leverage and influence the economy.

On the other hand, it indicated that:

> we must unswervingly encourage, support and guide the development of the non-public sector, and ensure that economic entities under all forms of ownership have equal access to factors of production in accordance with the law, compete on a level playing field and are protected by the law as equals.

That was the first time that competitive neutrality had been recognised and proposed in such an important political document in China.

Correspondingly, SOE reform is once again on the agenda, and has entered a substantive stage. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) has specified the overall direction of SOE reform. The first stage will broaden market access, develop a mixed ownership economy, and promote and actively introduce private capital and strategic investors. In the second stage, classified supervising of SOEs will be the focus of reform. The core of classified supervising is to clarify the policy business and the

competitive business in the same enterprises. Private enterprises will have more opportunities to participate in the process of SOE restructuring.
On 17 December 2013, Shanghai formally introduced the *Opinions on Further Deepening the Shanghai State-owned Assets to Promote the Development of SOEs* (hereafter, Shanghai Opinions). The main issues covered were:

- Gradually increasing the proportion of state-owned capital gains paid. Shanghai state-owned total assets exceed 10 trillion yuan, contributing to over 20% of Shanghai's GDP. However, a considerable number of SOEs account for a lot of resources but are economically inefficient. The Shanghai Opinions require that by 2020 the proportion of state-owned capital gains paid will be not less than 30%, and an evaluation system that evaluates the performance of state-owned assets income will be established.
- Shanghai SOEs will be supervised according to their classification, determined by their function. In other words, Shanghai SOEs will be divided into three categories: competitive enterprises, functional enterprises and public service enterprises. The classification may be adjusted dynamically. SOEs may also further be classified as industrial SOEs, capital management SOEs or financial SOEs.
- Promotion of equity incentives in qualified listed enterprises; promotion of market-oriented employment mechanisms; and improvement of the long-term incentive and distribution system. Specific measures include the full implementation of a fixed-term appointment system under contract management for SOE leaders, reasonably increasing the proportion of market-based hiring of managers, and promoting qualified state-controlled listed enterprises implementing equity incentive or incentive fund program.
- Establishing open and transparent state-owned assets trading platforms.

In addition, on 27 February 2014, the Guangdong provincial SASAC held the first matchmaking conference for SOEs and private enterprises. In the conference, the Guangdong SASAC publicly announced a total of 54 projects to invite private investments to participate in the restructuring of SOEs, which is expected to attract private capital worth more than 100 billion yuan, involving sectors such as transportation, building materials, metallurgy and mining, electricity, tourism, financial investment and health care. The vice chairman of the Guangdong SASAC said that in addition to a handful of SOEs assuming the functions of state policy or franchising, all other provincial SOEs could develop mixed capital arrangement. There is no minimum shareholding for the state-owned capital. In other words, private capital can control SOEs.

According to the Guangdong provincial government programme, Guangdong plans to fully complete the corporate restructuring of SOEs by 2015, and make mixed ownership companies account for more than 60% and 80% out of all enterprises by 2017 and 2020, respectively. Competitive SOEs will basically become mixed-ownership enterprises.

The above ideas on the reform of state-owned assets are in line with the top-level design of China's political leaders to deepen the market economic system and make the market play a decisive role in the allocation of resources. With the access of private capital, the development of mixed ownership and the implementation of classified regulation of SOEs, competitive neutrality is definitely the trend of the times.

3. Competitive Advantages and Disadvantages of Chinese SOEs Compared with Non-SOEs

3.1 *The competitive advantages of SOEs compared with non-SOEs*

3.1.1 Advantages of government subsidies

Before 2007, the Chinese government provided subsidies to a majority of SOEs to cover annual losses. After China joined the World Trade Organisation and promised to abolish all subsidies to SOEs, pursuant to Article 3 of the *Agreement on Subsidies and Countervailing Measures*, the Chinese government ceased to provide subsidies to SOEs after 2007, but certain SOEs in special sectors have been subsidised in a different way. For example, Petro China Co. and China Petroleum & Chemical Co. received subsidies of up to 76,349,000,000 yuan from 2007 to 2008. The reason for the subsidies, as explained by the relevant authority, was 'to safeguard the market supplies of crude oil and refined oil'. In comparison, private oil refineries have never received any refinery subsidy, and lack necessary downstream sales channels. Several stated-owned airline companies and certain other SOEs also obtained fiscal subsidies in 2008 and 2009.[70]

3.1.2 Advantages of credit finance

With a state-owned background and support from governments, SOEs obtain loans more easily from state-owned commercial banks, which have a dominant position in the credit market of China. In addition, as the assets owned by private enterprises are generally smaller than those of SOEs, private enterprises find it more difficult to obtain loans and have to bear higher costs for credit finance than SOEs. The preferential credit measures provided to SOEs by the banks include, but are not limited to, preferential interest rates and non-secured loans.

3.1.3 Advantages of personal relationships with the government

According to statistical analysis of the records of officials working in Ministries and Commissions at the national level, 56 officials, among a total of 183 (30.6%) at or above vice-

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[70] The Unirule Institute of Economics (2011), 'The Nature, Performance, and Reform of the State-owned Enterprises', p. 47.

ministerial level, working in 19 Ministries and Commissions at the national level, have experience working in SOEs. According to statistical analysis of the records of senior officers working in 47 Central SOEs, 115 senior officers have experience working in governments, averaging 2.45 persons in each enterprise. This demonstrates that there are strong personal relationships between the senior officers of SOEs and government officials, creating opportunities for SOEs to communicate with government and gain resources from the government departments.

3.1.4 Advantages of policy support

As just mentioned, SOEs have the advantage of personal relationships with government officials who enact relevant policies, regulations and decisions. Therefore, it may be possible for SOEs to gain knowledge of new policies or administrative decisions in advance, so that they can adjust their activities earlier than their competitors. In some extreme cases, a number of powerful SOEs will persuade relevant authorities to promulgate regulations and policies which are favourable to them.

3.1.5 Advantage of land-use rental

On the one hand, most SOEs in China incur lower costs to lease urban land than private enterprises. According to the PRC Constitution, the state owns urban land. If private enterprises want to use it, they must have the approval of government authorities and pay a land-use fee. This principle applies to private business enterprises, but not to all SOEs. In reality, the government often allocates land to SOEs for free, or at a cheap rental rate.

Also, SOEs can profit from rentals by re-leasing lands. For example, according to an administrative regulation called *Notice on Levying Business Tax on the Land Rental of China Petrochemical Corporation,* which was issued by the State Administration of Taxation of the People's Republic of China in 2004, the Ministry of Land and Resource of the PRC freely authorised the right to operate and manage 420 million square metres of land to China Petrochemical Corporation (hereafter referred to as the ‘Sinopec Group’) and approved the re-lease of the land by the Sinopec Group to China Petroleum & Chemical Corporation (hereafter referred to as ‘Sinopec Corp.’), which was controlled by Sinopec Group. After receiving the land-use rental from Sinopec Corp. each year, the Sinopec Group submitted 5% of this land-use rental as business tax to the tax authority and held the remainder of the rental as income. This practice means that the Chinese government loses 95% of the rental and permits the 95% rental as the SOE’s lawful income, which obviously aggravates the unfairness of costs and profits between SOEs and private companies.
Furthermore, the *2004 Annual Report of Sinopec Corp.* shows that the rental paid to Sinopec Group was 12.38 yuan per square metre. Accordingly, the annual rental income of Sinopec Group was 5.2 billion yuan and the business tax it paid was 260 million yuan (5.2 billion yuan × 5%). Therefore, Sinopec Group earned a profit of 4.94 billion yuan from re-leasing the freely

allocated lands. Comparatively, the average rental rate announced by *The Dynamic Monitoring System for China's Urban Land Price* was 3% at that time. Assuming this rental rate also applied to Sinopec Group, the due rentals that Sinopec Group ought to have paid from 2004 to 2009 would be up to 38.521 billion yuan.[71]

Table 1: The land rentals that the Sinopec Group should have paid on the basis of the average rental rate (2004-2009)[72]

	2004	2005	2006	2007	2008	2009
Areas of the Lands Leased by Sinopec Corp. (Million Square Meters)	420	420	420	420	420	420
Actual Rental Rate (yuan/Square Meters)	481	469	485	561	588	597
Due Rental (Million yuan)	6061	5909	6111	7069	7409	7522

Source of rental rate: Unirule Institute of Economics, 'The Dynamic Monitoring System for China's Urban Land Price' (www.landvalue.com.cn).

3.1.6 Advantage of mineral resource rental

The rental rate of mineral resources in China is much lower than in the world market. For example, the rental for coal resources in China accounts for less than 2% of the coal sale price. On the contrary, the average rental of coal resources in the world market is between 8% and 10% of the coal sale price, i.e. four to five times higher than the coal rental in China. Assuming the average rental rate in the world market applies to Chinese SOEs, the due coal rentals that Chinese SOEs should have paid from 2001 to 2009 would be up to 5909.625 billion yuan.[73] All of these rentals of mineral resources, which should have been a part of the costs of these enterprises, are turned into profits by Chinese SOEs.

[71] The Unirule Institute of Economics, 'The Nature, Performance, and Reform of the State-owned Enterprises', p. 40.
[72] *Ibid*, p. 40.
[73] *Ibid*, p. 44.

Table 2: The coal rentals that Chinese SOEs should have paid on the basis of the global average rental rate (2001-2009)[74]

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009
Coal rental that should have been on the basis of the average rate (Billion yuan)	14.460	17.136	18.653	24.308	34.036	37.980	45.355	53.637	58.883
Coal rental paid (Billion yuan)	2.933	3.341	3.591	5.915	8.553	9.385	10.381	11.283	12.682
Profit (Billion yuan)	11.527	13.795	15.062	18.393	25.483	28.595	34.974	42.354	46.201

3.1.7 Advantage of enterprise income tax

According to *The Enterprise Income Tax Law of the PRC*, public service companies can benefit from a reduction in, or an exemption from, enterprise income tax. Since many SOEs in China are in the public service sector, they can take the advantage of lower enterprise income tax and increase their profits.

3.2 *The competitive disadvantages of SOEs compared with private enterprises*

3.2.1 Broader corporate social responsibility

Firstly, compared with private enterprises, Chinese SOEs have higher welfare expenses because they have more employees and retirees due to their large scale and long history.

Secondly, as state-owned assets, SOEs undertake part of the social responsibility for governments. For example, in a recession period, SOEs have to promise not to lay off employees or even to hire those laid-off from other enterprises. Thus, to a certain degree, the autonomy of operation and personnel management of SOEs is restricted. A report named *The Indexes of Corporate Social Responsibility in China (2010)* shows that in the list of corporate social responsibility, there are 12 SOEs (which are central enterprises), two private enterprises and no foreign-owned enterprise among the leading organisations in social responsibility. The average score of the indexes for SOEs is 68.4, which is 3.1 points higher than that of private enterprises.

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[74] *Ibid*, p. 44.

3.2.2 Public welfare-oriented functions

Compared with the profit-oriented private enterprises, most SOEs are in business for public welfare. Their main business goal is to maintain the national economy and people's livelihoods. They are also required to keep assets and operations stable. Therefore, SOEs cannot freely invest in other sectors to increase profits as may be done by private enterprises. The reinvestments made by SOEs need to conform to national industrial policies and be approved following strict procedures.

3.2.3 Inefficiency of corporate governance

Due to direct supervision and control by government departments, the business operations of SOEs need to go through cumbersome administrative application and approval procedures, lowering the efficiency of SOEs and affecting their autonomy of operation. In addition, Chinese SOEs lack incentive mechanisms for operational innovation. Senior officers in SOEs, who are appointed by the relevant authorities, are subject to administrative penalties if an SOE’s creative operations suffer losses. Under such conditions, the managers and staff in SOEs are inclined to be uncompetitive and inefficient, which causes mechanisms of innovation in SOEs to rapidly degenerate.

3.3 *Conclusion*

In conclusion, SOEs in China gain many advantages through government subsidies, credit finance, a personal relationship with governments and policy support, while having the disadvantages of undertaking more social responsibility and public welfare-oriented functions, and inefficiency caused by their specific form of corporate governance. However, Chinese SOEs hold more competitive advantages than disadvantages.

4. SOEs and Anti-Monopoly Law (AML)

4.1 *Is there an exemption for SOEs?*

Article 7 of the AML provides that the state only protects the ‘lawful business operations’ of enterprises ‘within the lifeline of national economy and national security or the industries implementing exclusive operation and sale’. Furthermore, it emphasises that enterprises shall not damage the interests of consumers by virtue of their dominant positions. It is clear that enterprises in industries relating to security of the national economy and national security are governed by the AML in the same way as players in other industries. Therefore, the monopoly enterprises involved must not abuse their dominant position to eliminate and restrict competition.

Following the AML's official implementation, the Standing Committee of the National People's Congress promulgated the *Law of the People's Republic of China on the State-Owned Assets of Enterprises* (hereafter 'State-Owned Assets Law') to regulate the management, protection and development of state-owned assets. According to Article 7 of the State-Owned Assets Law, the state shall take measures to promote the centralisation of state-owned capital in 'important industries and key fields that have bearings on the national economic lifeline and State security'.[75] Moreover, Article 17 of the State-Owned Assets Law stresses SOEs' obligation to observe laws and administrative regulations. When they engage in business activities, there is no exemption for SOEs by virtue of their ownership.

When these two 'Article 7' clauses are read together, it can be understood that SOEs have, or will have, dominant positions in industries relating to economic stability and national security, that their lawful business operations are protected by the state, and that monopolistic conduct is always governed and regulated by the AML.

Although there is no exemption for SOEs, in legal practice the anti-monopoly authority still encounters issues arising from the 'privileges' enjoyed by SOEs. To illustrate, officials at the Ministry of Commerce of the PRC (MOFCOM) confirmed that China Unicom Limited (Unicom) and China Netcom Group Corporation (Hong Kong) Limited (Netcom) failed to file a pre-concentration notification with MOFCOM, as required under the AML, before they merged on 15 October 2008. Conversely, some insiders at the Research Centre of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) provided different points of view. In their opinion, mergers between SOEs directly under the central government should be controlled by the State Council, instead of being reviewed by MOFCOM under the AML. Article 48 of the AML provides that MOFCOM may penalise violators for failing to fulfil pre-concentration notification requirements. So far, it remains unclear whether MOFCOM will punish Unicom or Netcom. This example illustrates the present difficulties which the anti-monopoly authority might have to face.

4.2 *The government's determination to establish fair competition is ambiguous*

In February 2005, the State Council promulgated *Several Opinions of the State Council on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Sectors of the Economy* (hereafter called the 'Old 36 Opinions'), which systematically and 'expressly' encourage private investment. Actually, the 'Old 36 Opinions' was the first central government document to promote the non-public economy since the founding of the PRC. However, the 'Old 36 Opinions' does not appear to have been a success.

[75] According to SASAC, 'important industries and key fields that have bearings on the national economic lifeline and State security' include the military industry, petrochemical industry, telecom industry, civil aviation industry, coal industry and shipping industry.

Concerning market access, the ‘Old 36 Opinions’ stipulates that non-public capital should be allowed to enter industries and fields not forbidden by laws or regulations. Based on data collected by the National Development and Reform Commission (NDRC), up to May 2010, the proportion of private investment in traditional monopoly industries and fields was still quite low. For instance, it was 13.6% in the electricity, heat production and supply industry, 12.3% in the education industry, 11.8% in health, social security and social welfare, 9.6% in the financial industry, 7.5% in transport, storage and postal services, 6.6% in water conservation, environment and public facilities, and 5.9% in public management and social organisations.[76]

Against this backdrop, the State Council promulgated *Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment* (hereafter the ‘New 36 Opinions’). Representing a further step to deepen and explore a policy of private investment, the ‘New 36 Opinions’ stresses that the standards for market access and preferential and supportive policies should be open and transparent, that different investors should be treated equally, and that extra conditions should not be set exclusively for private capital. Nevertheless, the enforcement of the ‘New 36 Opinions’ continues to meet a number of obstacles. From a regional perspective, most local governments failed to formulate implementation rules for the ‘New 36 Opinions’. From an industry perspective, the progress for private investment in important fields such as railway, energy, finance and municipal public utilities is very limited. Additionally, some central government departments even issued policies against the targets and spirit of the ‘New 36 Opinions’.

With a view to implementing the ‘New 36 Opinions’ adequately, NDRC is investigating the enforcement effect and collecting relevant data. Subsequently, the State Council will debrief NDRC and assign the Supervision and Inspection Office of the General Office to inspect government departments. Thus, although obstacles do exist in enforcing policies encouraging private capital, the central government's determination to accelerate the reform of monopoly industries, actively transform government's functions and establish a market environment of fair competition is strong.

4.3 *The relationship between the AML and industry-specific legislation*

4.3.1 Application of laws

In China, the AML is implemented alongside industrial legislation for specific industries. In light of the problem of ‘conflict of laws’, coordinating the relationship between the AML and industry legislation is essential. Article 83 of the *Legislation Law of the People's Republic of China* provides the rule of ‘special provisions prevailing over general provisions’ to resolve this kind of conflict.

[76] Unirule Institute of Economics (2011), ‘Officials of NDRC meets the press regarding the “new 36 opinions”’, translated in: http://politics.people.com.cn/GB/1027/11603191.html.

With regards to competition issues within a specific industry, the AML is the general law and industry legislations are special laws. The AML protects fair and free competition in the entire market and makes the competitive economic system work, while industry-specific legislation safeguards the stability and the operational efficiency of the industry concerned. Although the focus of the AML and industry legislation overlap to some extent, compared to the AML, the latter provides more specific and detailed stipulations. Therefore, for monopoly conduct within a specific industry, industry legislation prevails over the AML, with the premise that the AML and the relevant industry legislation are formulated by the same organ. Otherwise, the 'conflict of laws' problem should be settled by the rule of 'the legislation of upper level prevails over the legislation of lower levels'. Accordingly, the AML prevails over administrative regulations, local regulation and rules. Furthermore, providing industry legislation does not provide related explicit stipulation, the AML shall be applied.

4.3.2 Interface between the anti-monopoly authority and the industry supervision authorities

In China, besides NDRC, MOFCOM and the State Administration for Industry and Commerce (SAIC) that take charge of AML enforcement, ministries and commissions under the State Council, as well as public institutions authorised by the State Council, exercise the power of supervision and inspection in specific markets. For instance, the State Electricity Regulatory Commission supervises the electricity supply market, while the Ministry of Industry and Information Technology inspects the telecom market. In order to maintain a sense of unity and safeguard the authority of the AML, it is important to successfully coordinate the relationship between the anti-monopoly authority and industry supervision authorities. Unfortunately, the AML does not provide rules to guide this coordination, notwithstanding related provisions that appeared in earlier drafts of the AML.[77] To some extent, the legislative process reflects the mighty status of industry supervision authorities in China, and reflects an improper positioning of the interface between competition policy and industry policy. Legally, the industry supervision authority has the obligation and power to protect competition. In practice, driven by the interest of a department, the neutrality to implement competition policy might be waived. Thus, the issue of whether monopolistic conduct within a specific industry is regulated by the industry supervision authority or anti-monopoly authority is a

[77] Article 43 of the drafted AML (submitted to the 22nd meeting of the Standing Committee of the 10th National People's Congress of the PRC) provides that '[t]he Anti-Monopoly Authority under the State Council shall investigate and deal with monopolistic conducts in accordance with this law. The competent departments and regulatory agencies of the State Council that are responsible for supervising competition in relevant industries or sectors in accordance with the provisions of laws and administrative regulations, may investigate and deal with monopolistic conducts in such industries or sectors in accordance with this law. Where competent departments and regulatory agencies of the State Council investigate and deal with monopolistic conducts in such industries or sectors involve significant affairs that eliminator restrict competition, they shall transfer them to the Anti-Monopoly Authority under the State Council for investigation. When investigating and dealing with significant affairs that eliminator restricts competition, the Anti-Monopoly Authority under the State Council shall consult the competent departments and regulatory agencies of the State Council.'

significant problem for China, especially in the process of economic transformation.

4.3.3 Limiting normative documents with anti-competitive effect

In China, industry legislation includes laws, administrative regulations and rules. So far, the 'conflict of laws' problem in the area of competition has not occurred at the level of industry laws and administrative regulations, notwithstanding that most of them were promulgated before the AML and have not been amended specially for the AML. This might suggest that provisions in industry legislation regulating monopoly conduct are few at the level of industry laws and administrative regulations. Additionally, no industry law or administrative regulation explicitly stipulates that SOEs' monopolistic conduct shall not be governed by the AML.

Nevertheless, at the level of rules, the 'conflict of laws' problem may occur. To illustrate, the *Provisions on the Administration of Alliance, Reorganisation or Restructuring of Civil Aviation Enterprises or Airports* is a rule promulgated by China Civil Aviation Administration (CCAA), the legislative purposes of which involve more than 'promoting the establishment of a fair, orderly and competitive market order'. Besides competition policy concerns, when CCAA reviews a merger case it also takes account of the impact on the civil aviation industry, industry policy, macro-control policy, safe production and flight. So when the AML authority (MOFCOM) reviews a merger control case it may conflict with CCAA, according to the different perspectives.

Except for industry legislation, a government department has the power to issue normative documents. In practice, normative documents do not have legal force, but their administrative force is influential and real. Actually, most provisions eliminating or restricting competition are stipulated in normative documents.

The petroleum industry may be taken as an example. In order to standardise market orders, enhance resource allocation efficiency and safeguarding state energy security, the State Council promulgated the *Notice on Screening and Rectifying Small Refineries and Standardizing the Circulation Order of Crude Oil and Fuel Oil* in 1999, which granted monopoly status in the oil wholesaling sector to three national corporations.[78] Subsequently, relying on the normative documents eliminating or restricting competition issued by central government departments and state government departments, the three national corporations successfully expanded their monopoly power from the wholesaling sector to other sectors, including importation, retail and transportation. For instance, in the transportation sector, the *Notice on Strengthening the Administration of Oil Transportation* promulgated by the Ministry of Railways (MOR) in 2003 stipulates that MOR may only accept oil transportation schemes submitted by China National Petroleum Corporation (CNPC) and China Petrochemical

[78] These three national corporations are the China National Petroleum Corporation (CNPC), China Petrochemical Corporation (SINOPEC) and China National Offshore Oil Corporation (CNOOC).

Corporation (SINOPEC). This prohibits other entities from operating in the oil transportation business. In the supply sector, the *Plan on Expansion of the Pilot Scope of Ethanol Gasoline* and the *Detailed Rules for Expansion of the Pilot Scope of Ethanol Gasoline* enacted by eight commissions and ministries in 2004 states that CNPC and SINPEC will take charge of producing and supplying ethanol gasoline. To implement the above normative documents, the *Measures to Promote the Use of Ethanol Gasoline in Heilongjiang Province* was formulated by the local government, stipulating that ethanol gasoline within Heilongjiang must be supplied by CNPC Heilongjiang branch exclusively.

The market power which they have in most sectors provides CNPC and SINOPEC with the ability to control the price in the petroleum industry, resulting in the majority of downstream enterprises established by private capital exiting the petroleum industry. By 2007, the number of privately owned petroleum wholesaling enterprises had decreased from 3310 to 663 (from 1998). Of the existing 45,000 service stations established by private capital, two fifths of them are reportedly on the verge of insolvency. Consequently, social welfare has been seriously harmed by normative documents, which are eliminating and restricting competition. Thus, re-examining and reforming normative documents that have the effect of restricting competition is essential.

At present, state-owned capital is centralised in industries and fields relating to state economic stability and national security, which usually involves some natural monopoly sectors. Furthermore, the subtle relationship between SOEs and government departments even includes state-owned monopoly and administrative monopoly. The interweaving of natural monopoly, state-owned monopoly and administrative monopoly has become a big obstacle to efforts to deepen the systemic reform of China's market economy.

5. Complaint and Supervision System

A competitive neutrality framework has not been officially discussed in China. However, the view is held that a series of measures to reform and supervise SOEs are part of a competitive neutrality framework, and that further market-oriented reform of SOEs will facilitate the establishment of a competitive neutrality framework.

To date, there is no complaint and supervision system directly related to competitive neutrality in China. However, there are some channels for complaint such as proposing bills regarding SOEs to deputies of the People’s Congress, political advisors to the People's Political Consultative Congress or members of some democratic parties.

In 2004, two bills, *Proposals to eliminate systemic obstacles of economic development and foster friendly environment for Non-State-owned economy* (No. 0190) and *Proposals to* *encourage and support private enterprises to help reorganise and upgrade SOEs* (No. 2349), were proposed by the Revolutionary Committee of the Chinese Kuomintang and the All-China Federation of Industry and Commerce respectively. The main contents of the two bills ensure the equality of SOEs and non-SOEs in terms of their legal status, remove restrictions on non-SOEs in terms of market entry in many industries, steadily resolve difficulties for non-SOEs in relation to investment and finance, unify the tax system for different enterprises, clean up and abolish policies that discriminate against or place restrictions on private enterprises, and further promote the transformation of government functions and the reform of administrative system. The main contents of these bills are fully reflected in *Some Opinions on Supporting and Guiding the Development of Non-state-owned Economy* issued by the State Council on 12 January 2005.

In addition, according to Article 9 of the AML, the Anti-monopoly Commission was established under the State Council with the responsibility of 'studying and drafting related competition policies'. This was the first time the notion of studying and drafting related competition policies in the form of legislation was raised in China. Competition policy includes the content of competition neutrality in itself. Provided that the Anti-monopoly Commission is empowered to establish and enforce a complaints and supervision system as part of a competitive neutrality framework, it will facilitate the coordination of the relationship between competition enforcement authorities and government regulation authorities and promote fair competition between SOEs and private enterprises, so that the unfair advantages of SOEs in competition will be minimised.

6. Case Studies

6.1 *Case study of the oil industry*

6.1.1 Development of the oil industry in China

Before 1987, the oil industry in China was a completely planned production system. The State Planning Commission and the State Economic Commission set up investment plans and mission objectives; the Ministry of Finance was responsible for appropriation; the Ministry of Geology and Mineral Resources undertook exploration; and the Ministry of Petroleum Industry was in charge of specific production and operation. All corporations were directly affiliated institutions of the Ministry of Petroleum Industry. Investment plans, product sales, personnel arrangements, cost accounting, salary grades, tasks indicators and other related contents were all determined by the relevant departments. All petroleum and related products were subordinated to the national comprehensive balance plan, allocated in a unified way and managed level-to-level. There was a unified purchase and sale channel for these products and corporations fulfilled tasks according to indicators.

After 1978, the oil industry made several reforms. In March 1982, China set up the China National Offshore Oil Corporation (CNOOC) for foreign cooperation in offshore petroleum drilling. In 1983, the government integrated the petroleum refining enterprises of all departments and formed the China Petrochemical Corporation (SINOPEC). In September 1988, the government abolished the Ministry of Petroleum Industry and turned it into the China National Petroleum Corporation (CNPC), which managed onshore petroleum corporations through overall restructuring. At that time CNPC, SINOPEC and CNOOC had become oligopolies in China's petroleum market. To be specific, CNPC monopolised onshore petroleum exploration and exploitation, SINOPEC monopolised petroleum refining, and CNOOC monopolised offshore petroleum exploration and exploitation. In 1997, the government set up the China National Star Petroleum Corporation (CNSPC) for business in the entire oil industry. In sweeping changes in 1998, the oil industry was restructured in China. The national oil business was divided between SINOPEC (CNSPC was integrated into SINOPEC in 2000), CNPC and CNOOC according to the divisions of South, North and offshore. CNPC mainly operates in northern China; SINOPEC mainly operates in southern China; and CNOOC mainly operates in the coastal areas that lie in southeast, southern and eastern China.

6.1.2 Market structure of the oil industry in China

In China, the government grants the three oligopolies (CNPC, SINOPEC and CNOOC) absolute monopoly in their fields of operation through relevant policies.

The three corporations are all vertically integrated corporations. However, the scope of their business is quite different. The business of CNPC is mainly oil extraction and transport, the business of SINOPEC is mainly oil refining and chemical production, and the business of CNOOC is mainly offshore oil extraction and refining.

There are several segments of the oil industry, including oil exploration and extraction, refining, sale (including crude oil and refined oil), import and storage. Overall, these three corporations basically monopolise all of these segments in China.

- **Oil extraction**

In China, by law only enterprises that have obtained extraction licenses issued by the central government can undertake the business of oil and gas exploration and extraction. Currently, only a small number of state-owned companies such as SINOPEC, CNPC and CNOOC enjoy these mining privileges. According to the *Regulations of the People's Republic of China on Sino-Foreign Cooperative Exploitation of Onshore Petroleum Resources* revised in 2001, 'The China National Petroleum and Natural Gas Corporation Group and the China National Petroleum and Chemicals Corporation Group (hereafter referred to as the 'Chinese petroleum companies') shall be responsible for business matters in respect of the exploitation of onshore petroleum resources in cooperation with foreign enterprises'. Furthermore, 'The China

National Offshore Oil Corporation shall take the overall responsibility for Sino-foreign exploitation of offshore petroleum resources of the People's Republic of China’. Although CNPC and SINOPEC also obtained managerial authority for offshore oil and gas resources in 2009, the structure of the three oligopolies has not been broken up.

According to the National Statistical Yearbook 2010, in the oil and gas extraction field, the proportion of state-owned assets reached 96.6% and the state’s proportion of industrial output was 94.7%. There are only a small number private enterprises in the field of oil refining and sales of refined products.

- **Oil refining**

In relation to oil refining, the *Opinions on Monitoring and Rectifying Small Refineries and Regulating the Order of Circulation of Crude and Product Petroleum* (Guo Ban Fa [1999] No. 38) promulgated by the General Office of the State Council in May 1999 states that ‘CNPC and SINOPEC can restructure the small qualified refineries by transfer, joint-venture, equity participation, acquisition or other methods pursuant to the law.’ The regulation gives CNPC and SINOPEC the power to integrate local refineries. Most of these refineries were private enterprises.

The *Special Plans on Mid-long Term Development of Petroleum Refining Industry* and *Special Plans on Mid-long Term Development of Ethylene Industry* issued in 2005 suggest that a market entry system should be adopted in the petroleum refining industry and that there should be a threshold for refineries’ scale. The plans also limit the regional distribution of refineries, which are generally permitted only in areas that are short of oil. On the one hand, these two plans raise industry standards and barriers to entry; on the other hand, they compress the space for private enterprises’ entry because only a few private enterprises are able to meet these conditions.

- **Wholesale of refined oil**

In relation to the wholesale of refined oil, document No. 38 stipulates that:

> All product petroleum produced by domestic refineries shall be wholesaled by enterprises of CNPC and SINOPEC. No other enterprises shall operate the business. No self-sale of refineries shall be permitted. The refineries, which sell product petroleum illegally, shall be forbidden to supply crude. The wholesale enterprises of product petroleum shall be rectified in 1999 and the qualifications for those enterprises without proper conditions shall be cancelled. CNPC and SINOPEC can restructure the qualified wholesale enterprises by transfer, joint-venture, equity participation, acquisition or other methods pursuant to the law.

Opinions on Rectifying and Regulating the Order of Product Petroleum Market Further (document No. 72) issued in 2001 further reinforces the monopoly rights of CNPC and SINOPEC. In relation to market access it states:

> The new construction of gas stations shall be controlled strictly, and the examining and approving procedure for new gas stations shall be standardised. As of the issuance date of these Opinions, new gas stations in all localities shall be built or wholly owned by CNPC and SINOPEC

In relation to wholesale:

> Refined oil shall be sold by CNPC and SINOPEC by wholesale. These two corporations shall formulate the distribution planning for national refined oil wholesale enterprises, and submit such planning to State Economy and Trade Commission for examination and approval. From the issuance date of these Opinions, new refined oil wholesale enterprises shall be reported by CNPC and SINOPEC to State Economy and Trade Commission for examination and approval.

In other words, no matter whether the new refined oil wholesale enterprises were state-owned or private, they were all subject to the control of the CNPC and SINOPEC. At present, the vast majority of gas stations are part of the three major oil companies, and only a small number of private stations are owned by private operators.

- **Supply and distribution**

In 2003, the Ministry of Railways issued the *Notice on Strengthening the Management of Petroleum Transportation* (Tie Yun Han [2003] No. 150). The notice stipulates that no railway bureau shall accept the service of petroleum transportation without the approval of CNPC and SINOPEC. This provision compels local and private refineries to choose road transportation, in circumstances where the cost of this mode is several times higher than railway transportation.

In addition, the *Plan for Expansion of Vehicle Alcohol Gasoline's Trial Use* and *Rules for the Implementation of Expansion of Vehicle Alcohol Gasoline's Trial Use* (Fa Gai Gong Ye [2004] No. 230) issued by eight ministries and commissions, including the National Development and Reform Committee in 2004, proposes that alcohol gasoline be produced and supplied only by CNPC and SINOPEC.

According to statistics from the Oil Circulation Committee of the China General Chamber of Commerce, at the end of 2006 there were 663 private oil wholesale enterprises in China, with 45,064 private gas stations; by 2008 two thirds of China's private oil wholesale enterprises had closed down, along with one third of its gas stations.

- **Imports of crude oil**

Currently, if an enterprise outside the CNPC and SINOPEC system wants to import crude oil, it must have a certification of a production plan arrangement issued by CNPC and SINOPEC to obtain customs' clearance or railway transportation. Even then, after importation, the crude oil must be bought back by CNPC and SINOPEC and the return sale arranged by them.

At present, China's crude oil imports can be divided into two categories: state traded and non-state traded. The privileges of state trading were authorised to five state-owned companies: SINOPEC, CNPC, CNOOC, SINOCHEN and Zhuhai Zhenrong. In addition to these five companies, under China's WTO accession agreement, since 2002 China has begun to allow some other enterprises to undertake crude oil imports by way of non-state trading. Currently, 22 private companies have obtained the qualification for non-state trading.

In recent years, a crack has emerged in the monopoly on importation. In June 2010, China ZhenHuaOil Co., Ltd, which belongs to the China North Industries Group, was granted the independent right to import crude oil without approval by CNPC and SINOPEC. In other words, ZhenHuaOil can import crude oil with its own direct quota and control. ZhenHuaOil is the third enterprise in China that can supply crude oil for its own refining enterprises. However, it is worth noting that ZhenHuaOil is still a state-owned company rather than a private company.

- **Reserve and storage**

In 2003 China began the construction of the state strategic oil reserve base.[79] Private enterprises that occupy an important position in the oil retail industry in China are extremely disengaged from the state strategic oil reserve. CNPC, SINOPEC and CNOOC have participated in the state strategic oil reserve base project from the beginning and are constructing the oil reserve base with the help of state investment.

At present, the market in the reserve section is being opened up. On 14 May 2010, the National Energy Administration invited public bidding for the opportunity to use social capacity as state oil reserves. Social capacity here refers to the storage capacity of oil companies except CNPC and SINOPEC, including some SOEs such as CNOOC. Although stakeholders concerned said that 'this is just a pro forma bid', the bid in fact ended the control of two oil giants in oil reserves because the national oil reserve was previously operated by CNPC and SINOPEC alone. For the first time, private oil enterprises can now take part in national oil construction and operation as equal operators. Among the six bid winners, Peng Lai An Bang and Lai Zhou Dong Fang are subsidiaries of state-owned enterprises controlled directly by the central government; Yan Tai Gang is a state-owned enterprise run by a local

[79] In order to guard against the risk of insufficient oil supply and safeguard national economic security, China had planned to establish a national strategic oil reserve system as early as 1993. For various reasons, the country didn't officially launch the first phase of the national oil reserve base project until 2003. Before this project, China had no established strategic oil reserve system; oil reserves were mainly dependent on the commercial reserves of SINOPEC, CNPC and CNOOC, and 21 days' worth of oil could be held in reserve. After the completion of China's strategic oil reserve system, the number of reserve days will increase to 90 days. The total investment in the project is more than 100 billion yuan and the project period is from 2006 to 2020.

government; Zhou Shan Shi Ji, Zhou Shan Jin Run and Zhe Jiang Tian Lu are private enterprises.

Thus, the three oil giants have controlled oil extraction and importation completely and they also have a monopoly position in oil refining. The oil production market, in other words, is completely monopolised by these three giants. At the retail level, CNPC and SINOPEC currently occupy most of the market. Since only a few licensed state-owned companies have the privilege of extracting, importing and supplying crude and refined oil, private enterprises are always at an extreme disadvantage when oil is in short supply and they are unable to obtain stable oil sources. For example, once CNPC and SINOPEC stop supplying oil for private gas stations, the private gas stations have to shut or be taken over by the two giants, as they have no access to oil. The two oil giants can control private enterprises in this way. Private gas stations are disappearing gradually and the petroleum market increasingly disadvantages customers. This situation would be greatly improved for consumers if China enacted a competitive neutrality policy.

According to statistics from the Oil Circulation Committee of the China General Chamber of Commerce, by early 2008, two thirds of the 663 former private wholesale enterprises had been shut, and one third of the 45,064 private gas stations had been closed down. The main reason for their failure was that they could not compete with state-owned gas stations with their stable oil and gas resources, while they were subjected to discrimination under a variety of policies. Besides, more than 10,000 private oil enterprises had large deficits and hundreds of thousands of people had to be laid off. Before 1998, 85% of the national refined oil market was made up of private oil enterprises and they paid tax of more than 100 billion yuan in that year. But now, the taxes paid by private oil enterprises are less than 20 billion yuan per year, due to the insufficiency of refined oil sources.

Chart 1: Market structure in the oil industry in 2010

	Exploration	Crude processing	Resale
CNPC	1.16	1.22	1.21
SINOPEC	0.46	2.11	1.40
Whole Nation	2.02	4.23	3.15
CR2	80.25%	78.72%	82.86%

Unit: 100 million ton

Source: Companies' annual reports and China Statistical Yearbook

6.1.3 The competitive advantages of state-owned oil enterprises over private oil enterprises

- **Policy advantages**

In the oil industry, CNPC was granted the oil exploration and development franchise under the *Circular of the General Office Under the State Council on the Approval and Transmission of a Report Submitted by the Department of Energy Concerning the Formation of China*

National Petroleum Corporation (Guo Ban Fa [1999] No. 38) in 1988, which continued the traditions of the planned economy period.

In 1994, the State Council approved and transmitted *Opinions Concerning Reform over Distribution System of Crude and Product Petroleum* by the State Planning Commission and the State Economic Commission, in order to strengthen the macroscopic management of the production and circulation of crude and product petroleum. With this regulation, oil circulation returned to the planned channel once again.

In May 1999, *Opinions on Monitoring and Rectifying Small Refineries and Regulating the Order of Circulation of Crude and Product Petroleum* (Guo Ban Fa [1999] No. 38) promulgated by the General Office of the State Council provided that ‘product petroleum produced by domestic refineries shall be wholesaled by enterprises of CNPC and SINOPEC. No other enterprises shall operate the business. No self-sale of refineries shall be permitted’, thus establishing an administrative monopoly position for CNPC and SINOPEC. In addition, Document No. 38 stipulates that ‘CNPC and SINOPEC can restructure the qualified wholesale enterprises by transfer, joint-venture, equity participation, acquisition or other methods pursuant to the law’, which gives them powers of integration over regional refineries.

In addition, Document No. 38 strengthens the three oil giants’ control over crude petroleum by stipulating that ‘[c]rude petroleum produced by CNPC and SINOPEC, domestically sold by CNOOC, produced by CNSPC and local oil wells, as well as crude imports shall be allocated in a unified way of national level. No self-sale of crude petroleum shall be permitted’. To enter into the upstream sector of the petroleum industry, private enterprises have to cooperate with CNPC to explore low-yield oil fields, which may be regarded as having no commercial value by CNPC, and all investment risks are borne by the private enterprises. Furthermore, 20% of crude petroleum explored must be delivered to CNPC for free, while the remainder would be sold to CNPC under a price set by CNPC.

The monopolies granted to the three oil giants are in administrative documents. In fact, competitive neutrality advantages are usually conferred by administrative documents. In particular, Document No. 38 is the major and direct legal basis establishing administrative monopolies in the oil industry. It is this document that directly limits the right of refineries and wholesale enterprises, except CNPC and SINOPEC, to undertake the wholesale of refined oil, and gives monopoly positions to CNPC and SINOPEC in the market of oil refining and refined oil sales. It should be noted that Document No. 38, promulgated by the General Office of the State Council, an internal subsidiary of an administrative organisation, should be recognised as an internal document without external effect in the opinion of this author. That is to say, this document cannot be externally enforced even if the legal reservation principle is not taken into account. Accordingly, this author believes the document should be deemed as a substantial violation of law, and should be confirmed as invalid. For the other documents that are not invalid, a revocation should be made due to the illegality resulting from the absence of clear legal authority. In short, this author is of the opinion that government regulations and policies contrary to competitive neutrality principles should be repealed or modified. The balance between the public benefit of such policies and their impact on competition should be considered before the policies are continued or implemented. In some cases, the same outcome may be achieved in other less anti-competitive ways.

- **Advantages of human networks**

8 out of 14 members of the board of directors of CNPC once served in government departments; 7 out of 15 members of the board of directors of SINOPEC once served in government departments. This regime of cross-appointments and identity swaps helps to build up a good relationship between the management of state-owned enterprises and administrative officials, which facilitates policy lobbying activities.

Chart 2: Proportion of members of Board of Directors of three oil giants from responsible departments

	2006	**2007**	**2010**
CNPC	55%	43%	43%
SINOPEC	55%	55%	47%
CNOOC	0	8%	9%
Average	37%	35%	3%

Note: the departments in charge of the industry include the Petroleum Administration Bureau, the Ministry of Petroleum Industry, the State Petroleum and Chemical Industry, the National Development and Reform Commission, the Ministry of Commerce, local planning commission and local economic commission. Members of BOD who once served in local government at the provincial level or above are included here.

- **Land advantages**

Before 2002, state-owned land in China was mainly transferred by assignment rather than by sale, and land was allocated without trade, but by administrative distribution. According to statistical data from the National Bureau, land transferred through assignment accounted for 87.2% of the total land transferred in 1995, and 89.5% in 1996.

The *Circular of State Administration of Taxation Concerning the Levy of Business Tax on Land Rent of SINOPEC* issued in 2004 indicated that the Land and Resources Department had granted SINOPEC the rights of operation and management over former allocated state-owned land totalling 4,200 million square meters, as well as the right to rent such land to the SINOPEC Limited Company.[80] According to the Circular, SINOPEC declares and pays business tax on land

[80] SINOPEC Limited Company is a subsidiary of SINOPEC. As of the end of 2010, SINOPEC Limited Company's had a total of 86,700,000,000 shares, SINOPEC holdings accounted for 75.84%, foreign shares accounted for 19.35%, and the public sector accounted for 4.81%.

rented all over the country to local tax authorities. In other words, SINOPEC Limited Company pays land rent to SINOPEC; the latter's only obligation is to pay business tax, which accounts for 5% of the total rent.[81] This Circular, although just one example, represents a general principle. That is, relevant administrative departments renounce rent on state-owned land, and acknowledge such rent as the lawful income of state-owned enterprises by levying a business tax on it. It should be pointed out that this Circular is beyond the scope of authorities which were endowed to the relevant administrative departments and therefore does not coincide with constitutional principles.

The SINOPEC Annual Report of 2004 stated that the rent paid by SINOPEC Limited Company to SINOPEC Group was 12.38 yuan per square meter. According to this, it can be calculated that the total rent SINOPEC obtains from the listed company is 5.2 billion yuan per year. The business tax on such rent is 2,600 million yuan, based on a 5% tax rate. In comparison to industrial land prices from China's urban land price dynamic monitoring system, SINOPEC Group failed to pay 38.521 billion yuan of rent to the country during the period 2004 to 2009 when compared with the market rental price, which is 3% of industrial land prices.

Chart 3: Land rent that should have been paid by SINOPEC from 2004 to 2009

	2004	2005	2006	2007	2008	2009
Land used by SINOPEC (billion square meters)	4.2	4.2	4.2	4.2	4.2	4.2
Industrial land prices (yuan per square meter)	481	469	485	561	588	597
Land rent that should have been paid (billion yuan)	60.61	59.09	61.11	70.69	74.09	75.22

Source for industrial land price: China Land Price Website

Chart 4: Land rent that should have been paid by CNPC from 2001 to 2010 based on market prices

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Industrial land price (yuan per square metre)	461	465	472	481	469	485	561	588	597	772
Land rent that should have been paid (billion yuan)	159	160	162	165	161	166	193	202	205	265
Amount unpaid	139	140	142	145	141	147	173	182	185	245

Source for industrial land price: China's urban land price dynamic monitoring system

[81] State Administration of Taxation, 2004.

- **Advantages from government subsidies**

Due to price control on petroleum products, the administrative price has always been higher than the price in international markets, especially after the year of 2008, as a result of substantial subsidies to state-owned monopoly enterprises. See the two charts below.

Chart 5: Comparison of resale price of diesel before tax between China and several countries

Country	2006	2007	2008	2009
Belgium	2.44	2.70	3.82	2.30
France	2.31	2.53	3.61	2.17
Germany	2.31	2.62	3.63	2.26
Italy	2.65	2.85	3.96	2.53
Netherlands	2.52	2.82	3.94	2.27
United Kingdom	2.36	2.55	3.58	2.15
United States	2.26	2.44	3.34	2.00
Average	2.41	2.64	3.70	2.24
China	2.36	2.62	3.17	2.96

Unit: dollars per gallon

Source: US Energy Information Administration (except for the data on China). The oil price in China is the average retail ceiling price set by NDRC for different types of petroleum.

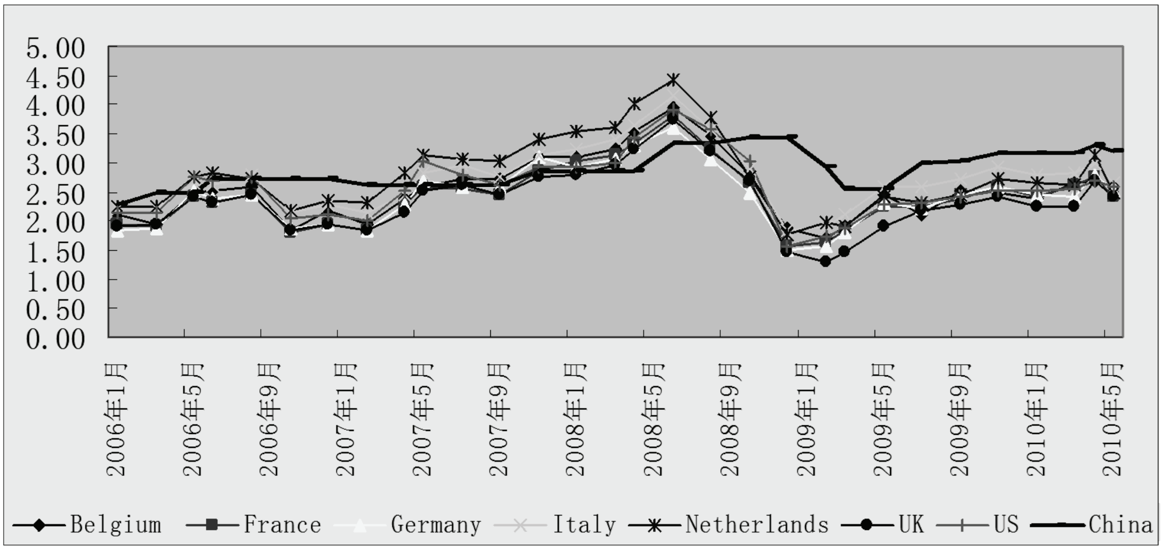
Chart 6: Comparison of resale price of gasoline before tax between China and several countries

Country	2006	2007	2008	2009
Belgium	2.26	2.55	3.20	2.21
France	2.12	2.41	3.02	2.15
Germany	2.15	2.43	2.91	2.15
Italy	2.42	2.70	3.34	2.46
Netherlands	2.49	2.92	3.51	2.31
United Kingdom	2.14	2.39	2.95	1.92
United States	2.40	2.62	3.09	2.19
Average	2.28	2.58	3.14	2.20
China	2.34	2.52	3.03	2.86

Unit: dollars per gallon

Source: as above.

Diagram 1: Comparison of resale price of gasoline before tax between China and several countries



Unit: dollars per gallon

Source: as above.

Diagram 1 shows that the price of gasoline before tax in China has been higher than that in other major countries. The average price of gasoline from September 2008 to June 2010 was 29.34% higher than that in other countries.

According to data from the US Energy Information Administration (EIA) and annual reports of CNPC and SINOPEC, the average price of crude oil in those years, except 2008, was slightly higher than the international oil price. In 2009, when the international crude oil price decreased significantly, the gasoline price set by CNPC and SINOPEC was reduced only slightly.

Chart 7: Comparison of oil price from 2006 to 2009

Year	WTI	Brent	Minas	CNPC		SINOPEC	
				Crude Oil	Gasoline	Crude Oil	Gasoline
2006	62.09	57.25	53.95	59.81	86.36	55.06	89.60
2007	60.81	60.50	63.87	65.27	93.86	56.48	98.21
2008	98.27	98.43	98.34	87.55	118.42	84.37	129.05
2009	38.89	34.33	36.63	53.90	112.95	45.14	124.79

Unit: dollar per barrel

Source: US Energy Information Administration website: http://www.eia.doe.gov/, and CNPC and SINOPEC annual reports.

Note: Unit of the price set by CNPC and SINOPEC was converted from yuan/ton to dollar/barrel according to the average exchange rate of relevant years.

The actual subsidies obtained from price margins can be calculated by multiplying the price difference of the oil products listed above in China and other countries by the retail sales of petroleum by CNPC and SINOPEC.

Chart 8: Retail sale of petroleum produced in CNPC and SINOPEC 2006-2009

	2006	2007	2008	2009
CNPC	47.33	52.34	58.60	61.22
SINOPEC	72.16	76.62	84.1	78.9
Total	119.49	128.96	142.70	140.12

Unit: million ton

Source: CNPC and SINOPEC annual reports.

As the quantities of gasoline and diesel sold in gas stations are not included in the CNPC and SINOPEC annual reports, a hypothesis is proposed that the annual sale of gasoline to diesel is in a ratio of 1 to 2. Based on this ratio, we can calculate the difference between average sales income in China and that in major countries. From 2006 to 2009, the total difference of sales income caused by price gaps is about 107.1 billion yuan.

Chart 9: Subsidies received by CNPC and SINOPEC

	CNPC	SINOPEC	Total
2005	-	9,415	9,415
2006	-	5,000	5,000
2007	1,197	7,381	8,578
2008	16,914	50,857	67,771
2009	1,097	0	1,097
Total	19,208	58,238	-

Unit: million yuan

Source: CNPC and SINOPEC annual reports.

- **Operational advantages of vertical integration**

The vertical integration of operations by the three oil giants contributes to a squeeze on private enterprises' profits by cross-subsidy. CNPC and SINOPEC, for example, can transfer profits from the refining sector both upstream and downstream through vertical integration and can apply for financial subsidies because of losses in refining. However, private refineries have little bargaining power when confronted with CNPC and SINOPEC due to limited crude oil supplies and low market shares. Therefore, they have no other choice but to passively accept the price of crude oil and deliver petroleum products to wholesale enterprises under the control of CNPC and SINOPEC. This results in a profit squeeze in both the upstream and downstream markets of the oil industry. The control of the refining sector by CNPC and SINOPEC means that they can also control retail sales of refined oil. These oil giants have the ability to further seize and squeeze the profits of private gas stations in the retail sector by increasing wholesale prices and decreasing the retail price, in order to reduce the competitiveness of private gas stations.

In addition, the three oil giants can exclude upstream and downstream competitors by utilising their existing dominant positions. Take CNPC's practices in the pipe gas sector as an example: the gas industry in China's urban areas is basically market-oriented with several main gas companies, such as Hong Kong & China Gas, China Gas, Xin Ao Gas and China Resources Gas. In order to enter the gas industry, CNPC integrated all its gas companies to establish the Petro-china Kunlun Gas Co., Ltd., whose operational objective is to develop markets in the gas sales sector. During the promotion of its gas business, many local private gas companies were squeezed out of the market. As CNPC has achieved an absolutely dominant position in the gas extraction and refining market, it may exclude market participants in the gas retail market via vertical agreements with local governments. CNPC has entered into agreements with many provinces based on its abundant gas resources, which transforms gas markets in urban areas. The private gas enterprises, which were once leaders in the gas retail market, have a gloomy future. Therefore, with its monopoly advantage, CNPC has developed vertical integration and extended its business to upstream and downstream markets. This restricts competition and hinders the privatisation of public utilities. All of these activities may be abuses of dominant positions, violating the Anti-Monopoly Law.

6.1.4 Latest developments in the oil industry

After the Third Plenary Session of 18th Central Committee of the Chinese Communist Party, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) began to draft *Opinions on Further Deepening SOE Reform* (hereafter referred to as 'SOE Reform Opinions'). It is reported that SASAC planned to accelerate the introduction of a number of private capital investment projects in fields such as oil, electricity, railways, telecommunications and public utilities. After several modifications, the SOE Reform Opinions has now been handed over to the State Council for approval, and is expected to be introduced after the National People's Congress and the Chinese Political Consultative Conference, both of which will be held in March 2014.

The core of the oil industry reform is to promote the marketisation of resources and energy. Since 2013, the National Development and Reform Commission (NDRC) has held various seminars related to oil reform, and in early 2014 the National Energy Work Conference highlighted the significance of studying reform plans in the oil and gas sector and promoting an improved oil pricing mechanism. A top-level design aimed at expanding energy sector liberalisation gradually became clear. It will become the main energy liberalisation policy to release oil and gas resources monopolised by several major oil SOEs, to unleash midstream oil and gas pipelines, and to liberalise the import and export of crude oil products and natural gas. As such, it is envisaged that a diversified resource supply market will be gradually formed.

The right to import crude oil, or the crude oil import quota, has always been the exclusive privilege of several major oil SOEs. However, Ji Xiaonan, the Chairman of the Supervisory Board of key State-owned enterprises, recently stated that 'in terms of crude oil imports, the State Council has decided to release part of the crude oil import market, that is to say, 10 million tons of crude oil import quota will be released to private enterprises annually.' It is expected that private enterprises will soon obtain crude oil import licenses or quotas.

In addition to the import and export of crude oil, the markets of oil refining and the import and export of oil products are also changing. The market-oriented reforms related to the refining and sale of oil are the most clear. The refining and oil products sectors will gradually complete the marketisation process. Notably, on 19 January 2014, SINOPEC announced that all directors of the enterprise had unanimously adopted a motion to restructure its high-quality assets-oil sales business, and to introduce social and private capital to achieve mixed ownership management. According to SINOPEC's announcement, the ratio of shareholding by social and private capital will be determined based on market conditions. Currently, the Board has authorised the chairman to exercise the following authority in the case of social and private capital ratio accounting for less than 30% shareholding: 1) determine investors, shareholding ratio, the terms and conditions of equity participation programs and their implementation; and (2) sign transaction documents and other relevant documents, and handle procedures related to aforementioned matters such as approval, registration, filing and disclosure. Currently the public capital stock can be up to 30%. However, this does not indicate that social and private capital cannot exceed 30 percent in the future. According to estimates, SINOPEC's sales turnover amounted to almost 1.5 trillion yuan. If 30% of social capital is involved in the calculation, the size of the private capital market will reach 5,000 billion yuan. The mixed ownership reform started by SINOPEC is likely to be used as a source of reference by other domestic oil SOEs.

Finally, in the field of oil and gas pipeline construction, the government has also begun to explore the coordination of both the public and private sectors. Since most of the domestic pipelines were constructed and operated by oil SOEs in the past, small and medium enterprises and downstream gas exploration distributors have had to rely on oil SOEs to survive. The *Regulatory Measures on the Fair Opening of Oil and Gas Pipeline Facilities*, a new policy aimed to push oil and gas pipelines to open to third-party market players, took effect on 1 January 2014. It may therefore now be a viable option for private enterprises with sufficient cash flow to enter this field.

6.2 *Case study of the cement industry*

As the successor to a state-owned building materials manufacturer, the China National Building Material Group Corporation (The Group) was established in its current form after reorganisation in 2005. Its main subsidiary, China National Building Material Company Limited (CNBM), a HK listed company, presently focuses on four main business segments: cement, lightweight building materials, fibreglass and composite materials, and engineering services.

In 2010, cement comprised CNBM's largest business segment, accounting for 73% of total revenue, and making a significant contribution to the rapid growth of this company. CNBM was also the largest wind power blade producer in China, Asia's leading producer of lightweight building materials and also the world's leading fibreglass manufacturer. Since 2010, CNBM has become the largest cement producer in China, with about a 10% market share.

The situation was very different before 2006. In 2002, China's cement was produced by approximately five thousand enterprises, most of which were small- and medium-sized private enterprises. CNBM had a wide range of competitors in cement markets. At that time, the capacity of CNBM was small, with only a few production lines. Since 2005, to deter overcapacity and to rationalise the cement industry, the Chinese government imposed economic policies to push forward structural adjustment, in the hope of shutting down small firms while creating large conglomerates. In the years that followed, the Group experienced a dramatic expansion in the cement industry.

After CNBM decided to diversify its activities in the cement industry in 2006, it set out market integration and regional strategies. CNBM actively pushed forward capital restructuring, eventually acquiring approximately 200 local producers in Huaihai, the Southeast and the Northeast. As cement must be distributed within a geographically limited area, market integration often followed a regional strategy. In the above regions, CNBM achieved 50% local market shares and established pricing power.

Financing capability was key to the success of CNBM's expansion in the cement industry. CNBM preferred to acquire 100% of target cement firms and the amounts involved were therefore substantial. In 2009 alone, CBNM spent over 6.2 billion yuan acquiring cement firms.[82] Committed to the acquisition of cement firms, between 2008 and 2012 the total assets of CNBM increased from 5.8 billion to 24.6 billion, with a high level of debt.[83] The commercial banks provided strong and continuous support to CNBM's rapid pace of expansion. By mid-2012, fifty Chinese commercial banks, including the 'big four', gave 98.7

[82] Bower, Joseph L. and G. A. Gonovan (2011), 'Rolling Up China's Cement Industry', *Harvard Business School*, 28 October.
[83] CNBM Co. Ltd., *2012 Annual Report*, p. 216.

billion yuan of loans to CNBM, of which 88.8 billion yuan are credit loans.[84] This is unimaginable for privately owned enterprises (POEs) in the cement industry. POEs typically have difficulty borrowing money in the first place, and few financing channels are open to them. Lenders hesitate to lend to them, and when they are willing, borrowing costs are very high. The cost structure for cement is very simple: coal, power, and limestone account for about 85% of production costs. The Chinese government's macroeconomic policies meant that cement firms' financial positions became precarious.

After obtaining market power through acquisitions, CNBM started to undertake anticompetitive conduct to exclude its competitors and eventually control the market price. Under CNBM's vertical arrangements with local distributors, the distributors would refuse to deal with producers providing lower prices, which usually indicates a better resale price. The impairment of price competition in this way meant that competition in such a highly concentrated market was very weak.

Therefore, this corporate finance advantage helped CNBM to expend dramatically and play a leadership role in this industry.

7. General Approach to Competitive Neutrality

The approach to competitive neutrality should be set in accordance with the social and economic environment of each country. Unlike in a free market economy, the Chinese government exercises its power and functions to allocate the social and economic resources of the Chinese domestic market. POEs often face imbalances in economic terms, because of the preferential treatment granted to SOEs by this visible hand, both in natural monopoly and competitive industries. Regarding competition policy as a fundamental economic policy includes a consideration of competitive neutrality. To do this China will need to move to further marketisation.

A general approach in China's jurisdiction should be as follows:

Firstly, political and economic reform should go further and deeper. To realise sustainable economic and social development, the boundaries between the government and the market should be redefined, and an equitable and free competitive order should be established, including fair relationships between SOEs and POEs, enabling POEs to access production. This is essential.

Secondly, China must encourage a strong competition policy, together with measures of free

[84] Jin Huiyu (2013), 'Billions of Short-term Debt of CNBM', *First Financial Daily*, 12 March. Under credit loans the borrower does not need to provide a mortgage or third party guarantee.

trade, deregulation, capitalisation and privatisation. The objectives of competition policy should have priority over other economic policies.

Thirdly, in the field of economic monopoly enforcement, governments should strictly curb their administrative monopoly conduct at central and local levels. Judicial review covering legislation and normative documents that has an adverse effect on competition should take place. A high level of anti-monopoly enforcement should apply in the field of administrative monopoly.

Fourthly, governments should strictly control exclusive business conduct by SOEs, which extends their legal monopoly power to related competitive markets. Maintaining active competition in unregulated markets is even more important than deregulation.

This chapter does not recommend establishing a complaints process as a distinct system from the anti-monopoly enforcement mechanism at this stage. It must be recognised that China is in the process of marketisation, and active and mature markets have not yet been established in a large number of industries. At this stage, government failures are more serious and frequent than market failures. Without a decision to promote political and economic reform, the government does not have a real motive to change the imbalances and weaken itself or its 'arms' – SOEs' economic advantages. A complaint process under these circumstances would not provide any assistance.
Therefore, at the policy level, developing a strong competition policy and focusing on the exit of SOEs from competitive markets should be the priority of the state assets policy. At the legislative enforcement level, strictly curbing administrative monopoly by governments and economic monopoly by SOEs are optimal measures to achieve competitive neutrality, taking into account the benefits, costs and reality.

8. Conclusion

It cannot be denied that the reform of SOEs is very difficult for a large socialist country like China. Moreover, the structure of SOEs in China is extremely complex due to the traditional system. In the view of this author, the market-oriented reform of SOEs is not an arbitrary and independent action. In fact, the reforms are carried out under the guidance of the *Policy of Strategic Restructure of State-owned Economy* (hereafter referred to as 'SRSE Policy'). On the whole, SRSE Policy is the logical start and fundamental principle of embracing competitive neutrality in China. To be more specific, SRSE Policy means promoting the allocation structure of state-owned assets and modifying the organisational structure of SOEs. This policy requires that SOEs be withdrawn gradually from competitive fields in order to establish a system of modern enterprises adhering to market-oriented operations. Therefore, all exploratory measures and achievements must be fully appreciated under the guidance of this policy.

The reform has not been accomplished yet, though it has obtained initial results. Obstacles exist in the establishment of modern management systems, as the old economic system still affects SOEs. For instance, SOEs do not have the full right to price their goods or services, and management autonomy is not complete given the level of administrative intervention. In addition SOEs bear too many historical burdens, such as social security obligations. Moreover, experts in academic circles and the governments hold different opinions on the reform. Nevertheless, the majority of the former believe that the following issues are the most prominent: first, that the operation of SOEs is still inefficient for systematic reasons; second, some SOEs in monopolised industries have been overly concentrated, as under the shelter of natural monopoly, they take plenty of excessive profits; and third, there are still many SOEs in competitive fields, which may abuse the advantages that derive from being state-owned assets when competing with the private sector.

The issues mentioned above are key points for the further reform of SOEs and concrete measures will have to be taken within the framework of SRSE Policy. Specifically, three important steps could be taken. First of all, SOEs should be defined as special enterprises despite their commonality with private enterprises. Thus SOEs must bear special obligations and responsibilities so as to be compatible with an integrated market. In addition, to create a fair and just competitive mechanism for most market players, SOEs should gradually withdraw from general competitive industries. At the same time, the competition doctrine and relevant measures should be introduced into natural monopoly industries. However, there are fierce debates on the relation between SOEs and competitive industries and the scope of SOEs regarding this point. Finally, in order to tackle the question of whether SOEs should enter or withdraw from competitive markets, efforts should be made as follows: to deepen the reform of the management and organisational system for state-owned assets, to separate the role of government bodies as the contributor and regulator of SOEs, and to operate and manage state-owned property in a market-oriented manner rather than by administrative means.

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China's Approach to Reforming Infrastructural Services: The Role of SOEs

Alberto Gabriele*

1. Introduction: The Strategic Role of Infrastructure Services

Strategic services activities play, both directly and indirectly, a crucial role in providing physical and human capital. They also exert other ancillary, supporting and enabling effects on a country's economy and social fabric as a whole. Most have very strong backwards and/or forward linkages with the goods-producing (primary and secondary) sectors, and with non-strategic, commercial services sectors. Hence, they have a strong and recognisable impact on systemic inter-sectoral productivity within a country and on its international competitiveness. This impact is relevant over a temporal continuum ranging from the present to the distant future. Therefore, strategic services are crucial to a country's development and cannot simply be left to the vagaries of the market. Yet, interventionist policies in these sectors' strategic services can take various forms, be compatible with diverse forms of market structure and regulation, and may involve direct provision through SOEs.[85]

There are two major categories of strategic services: infrastructure services and social services.[86]

Mature and advanced capital-intensive and skill-intensive infrastructure service industries (energy industries, transportation and telecommunications) constitute the core of infrastructure services, along with a number of other service activities characterised by a wide range of technologies. In a slightly more indirect sense, financial services are also strategic, taking into account their crucial role in enabling investment activities, reducing transaction costs and fostering (or, if poorly regulated, disrupting) macroeconomic stability.[87]

Other strategic services, aimed at fostering the accumulation of highly-skilled human capital and the absorption and development of new technologies, are 'lighter' in nature: this is the case with R&D and higher education activities. The other strategic services sub-sector is

* UNCTAD DITC, Geneva. The author would like to thank Max Montgomery and Graham Mott for their very useful comments. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the organisation or of the governments of its member countries.

[85] Gabriele, A. (2005), 'Strategic Services Policies and International Trade Integration In Vietnam', *Journal of Economic Integration*, 20:2, pp. 263-293.

[86] Some of the most important strategic services sectors can be seen as belonging to more than one set.

[87] See UNCTAD (2011), 'Services, Trade and Development', by Mashayekhi, M., M. Olarreagha and G. Porto, available at: http://unctad.org/en/Docs/ditctncd2010d5_en.pdf.

constituted by social services that, while also targeting the population's basic needs, are fundamental for the formation and development of a country's labour force and human capital.

This chapter focuses on the first category of strategic services, that of infrastructure services, and is organised as follows. Section 2 illustrates the potential benefits and risks that can stem from liberalising or reforming previously monopolistic infrastructural services markets in order to achieve a certain degree of competition. Section 3 illustrates the main features of China's approach to reforming infrastructural services sectors and argues that this approach is substantially consistent with the country's peculiar, mixed[88] socioeconomic structure. Section 4 focuses specifically on the telecommunications sector and Section 5 discusses the relevance of the OECD principles to SOEs' governance and competitive behaviour in the Chinese context. Section 6 proposes a systemic interpretation of infrastructural services reforms. Section 7 concludes.

2. Reforms in Infrastructure Services: Opportunities and Challenges

2.1 *The liberalisation drive*

The worldwide trend in favour of trade openness, market regulation and the retreat of the state from economic activities, which peaked in the 1990s and still informs the reform programmes of many developing countries and the agenda of international financial institutions, affected all infrastructure services industries to varying degrees.

Liberalisation of a sector of economic activity characterised by high levels of government intervention and regulation (usually under monopoly conditions) consisted, broadly speaking, of a shift towards market regulation, which was originally supposed to be guided by the principles of free competition. However, in carrying out reforms, governments aimed not only to enhance 'static' efficiency (i.e., letting infrastructural industries work more efficiently with the same endowment of resources and technology), but also to achieve other, longer-term goals, such as attracting FDI, boosting innovation and technical progress, combating corruption, and releasing scarce planning and management resources at the state's disposal for purposes other than hands-on enterprise management.

Another compelling reason to liberalise infrastructural services industries was that technical change and globalisation trends have transformed old naturally monopolistic industries into sectors that are amenable to a certain degree of market competition. The sector where this

[88] A mixed economy is '[a]n economy that uses both market signals and government directives to allocate goods and resources'. See: Schiller, B. (2010), *The Micro Economy Today*, McGraw-Hill/Irwin, p. 15.

tendency is most evident is that of telecommunications, but technical changes are transforming (to varying degrees) other infrastructural services, such as energy, transport and finance.[89]

A degree of market liberalisation has therefore become a necessary condition, not only to achieve the static benefits of competition (such as short-term allocative efficiency), but, more importantly, to capture its dynamic advantages - most significantly fast technical progress. In this respect, as developing countries are not (by definition) global technological leaders, most often the only way for them to access modern technologies is to strike deals with foreign-owned transnational corporations (TNCs).

2.2 *The limits of spontaneous market regulation*

Over time, however, it has become evident that de-monopolised infrastructure industries cannot be expected to be optimally regulated by the spontaneous mechanisms of textbook, free competition. This is due to a number of factors, including the stubborn persistence of elements of monopoly brought about by the very nature of these sectors. As a result, infrastructure service markets often retain strong barriers to entry and very strict interdependency with government institutions. This leads, at best, to oligopolistic competition in markets among a small number of enterprises characterised by strong economies of scale and scope, technological path-dependency and an array of positive and negative externalities. Moreover, traditional public services arguments (such as the social advisability of pursuing universal access to essential services) maintain their relevance. As the UNCTAD Secretariat notes:

> As a result, a consensus emerged on the key role of regulation and institutions: Maximising the positive contributions of infrastructure services to pro-development outcome requires good regulation and institutions … Regulatory parameters thus need to be tailored to specific sectoral and local conditions, as regulatory design and institutional arrangements matter greatly for sectoral performances.[90]

The reformers' task was not easy. On one hand, it was essential to capture some of the benefits stemming from the judicious introduction of market forces and competition. On the other hand, the imperative to rein in strategic sectors that, by their own nature, confer a

[89] In some special cases, technical change (which is, of course, the key to prosperity and socioeconomic progress under normal circumstances) ends up not being unambiguously synonymous with increased welfare. For instance, the global financial crisis that began in the late 2000s has shown that excessively fast and unregulated technical change in strategic sectors can lead to disaster.
[90] UNCTAD (2013), 'Trade, Services and Development: the Regulatory and Institutional Challenges', Note by the UNCTAD Secretariat, Trade and Development Board, Trade and Development Commission, Multi-year Expert Meeting on Trade, Services and Development, First session, Geneva, 25-26 February 2013, Doc. TD/B/C:I/MEM:4/2, p. 1.

significant degree of monopoly power to incumbent players implied severe institutional and regulatory challenges. Taking into account this complexity, many countries have chosen mixed policy options, covering a vast range of specific combinations of state and market forces under a regime of (more or less forceful) managed oligopolistic competition. Typically, private firms coexist and compete with public enterprises and joint ventures. Under this model, in principle, setting up regulatory agencies and/or specialised competition-enforcing authorities might constitute the best institutional arrangement, but in practice this is not always governments' choice. In any case, as public and mixed enterprises are important actors, ministries and/or specialised state agencies retain a significant degree of influence.

A variant of this policy option is de-monopolisation accompanied by the splitting of the formerly dominant SOE and/or the creation of other, newly-established SOEs. Under this variant, various SOEs are expected to compete in the market, but one of two conditions applies:

- no access is allowed to either domestic or foreign private players;
- access to foreign private players is allowed only under the joint venture modality.[91]

Various forms of the mixed model prevail in some, most, or all infrastructural services industries in China, India, Vietnam and many other developing countries in Asia, and, to a lesser extent, in Latin America, Africa, the formerly socialist countries in Europe and Central Asia and in many developed countries.

3. The Chinese Model of Structural Reform in Strategic Infrastructural Service Sectors

3.1 *The key role of SASAC*

Since the 1990s, the focus of China's industrial and technology policies has shifted progressively from the establishment of a vast and competitive national production base to the pursuit of 'indigenous innovation', with the quantitative and qualitative strengthening of the National System of Innovation (centred on the key principle of promoting cooperation between universities and research centres, on the one hand, and productive enterprises, on the other hand). This had one of its most momentous passages with the launching of the 15-year Science and Technology plan in 2006.[92]

[91] Usually, foreign TNC form joint ventures with local SOEs, with the latter retaining a controlling share.

[92] See Serger, S. S. and M. Breidne (2007), 'China's Fifteen-Year Plan for Science and Technology: An Assessment', *Asia Policy* 4, pp. 135-164; Gabriele, A. (2001), 'Science and Technology Policies, Industrial Reform and Technical Progress in China: Can Socialist Property Rights Be Compatible With Technological Catching Up?', UNCTAD Discussion paper no. 151; Gabriele, A. (2002), 'S&T Policies and Technical Progress in China's Industry', *Review of International Political Economy*, 9:2, pp. 333-373; Gabriele, A. and H. Khan (2010), *Enhancing technological*

The role of the state in the country's industrial development was also re-emphasised according to the 'grasping the big and enlivening the small' principle, leading to the consolidation of a small elite of very large state-owned enterprises (SOEs) and state-controlled mixed enterprises (SCMEs), under the guidance of the State Asset Supervision and Administration Commission (SASAC):

> SASAC is the main management authority of China's vast SOE system. SASAC is responsible for streamlining the management of state-owned assets and advancing regulations that foster state asset development. Additionally, SASAC is responsible for regulating China's roughly 250 industry associations.[93]

SASAC is entrusted to manage and own these elite enterprises, and – according to China's Company Law – is endowed with vast powers and responsibilities, as it:

> performs investor's responsibilities, supervises and manages the state-owned assets of the enterprises under the supervision of the Central Government (excluding financial enterprises), and enhances the management of the state-owned assets … shoulders the responsibility of supervising the preservation and increment of the value of the state-owned assets of the supervised enterprises … advances the establishment of modern enterprise system in SOEs, improves corporate governance, and propels the strategic adjustment of the layout and structure of the state economy … appoints and removes the top executives of the supervised enterprises, and evaluates their performances.[94]

SASAC also strives to speed up and govern the Darwinian selection process of 'grasping the big and enlivening the small':

> SASAC indirectly reinforces the elite status of central firms by forcing them either to grow to become one of the top two or three firms in their sector or to be taken over. SASAC … has long held that the number of central firms will be reduced to significantly fewer than 100 within the next few years,[95] so that only the more efficient firms should survive. This has touched off a furious scramble to expand beyond the cut-off point[96]

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[93] US-China Business Council (USCBC) (2013a), 'State Asset Supervision and Administration Commission (SASAC)', Update: 11 June 2013; USCBC (2013b), 'An Introduction to the US-China Business Council': https://www.uschina.org/member.html.

[94] SASAC (2013), 'Main Functions and Responsibilities of SASAC'.

[95] By March 2013 there were 115 central government-controlled companies under SASAC. Their number will probably shrink further in the near future (Caixin 2013, CNPC President Takes over at SASAC).

[96] Naughton, B. (2007), 'SASAC and Rising Corporate Power in China', *China Leadership Monitor*, No. 24, p. 2.

In practice, however, SASAC is not always successful in reining in the behaviour of the large enterprises under its control, as top SOEs enjoy a high degree of wealth and influence that enhances their operational and financial autonomy.

3.2 *China's approach to the reform of infrastructural services*

It is in this context of profound and rapid change focused on a renewed and enhanced understanding of the role of the state in general, and of SOEs and SCMEs in particular, that a model with some distinctive characteristics and inter-sectoral commonalities has been taking shape in the domain of strategic infrastructure services in China.

China's approach to reforming strategic infrastructure service sectors revolves around the following key features: it is structured around a small number of SOEs and/or SCMEs,[97] one of which retains a dominant position; in some, but by no means all cases, SOEs and/or SCMEs act in cooperation with foreign TNCs (via business cooperation contracts (BCCs),[98] joint ventures, and/or similar legal arrangements); the resulting market structure is an oligopolistic, moderately competitive one, jointly moulded by government policy guidelines and by a WTO-compatible independent public regulatory agency.

Such direct and indirect strategic control of crucial assets and mechanisms of the national economy enables (at least in principle) the state to formulate and implement an advanced form of planning, focusing on the speed and the qualitative characteristics of the accumulation process.

In this context, China's policy makers have been implicitly carrying out a complex exercise in constrained dynamic optimisation, which has inevitably implied significant trade-offs, and could only lead (in the best scenario) to what might be considered a second-best solution. Planners' goals were (and still are) multiple and, while not mutually incompatible, imply reciprocal trade-offs, and thus must be assigned proper weights. The major goals, in physical capital-intensive strategic infrastructural services such as energy, transportation and telecommunications,[99] were as follows:

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[97] Actually, SOEs prevail in the domain of strategic infrastructural services. SCMEs have progressively become the preferred form of enterprises in non-infrastructural manufacturing industries operating in sectors characterised by strong oligopolistic competition in global markets (see Gabriele, A. (2010), 'The Role of the State in China's Industrial Development: A Reassessment', *Comparative Economic Studies*, 52:3, pp. 325-350).

[98] A business cooperation contract (BCC) is signed by multiple parties, typically by a foreign investor and a local company or the government with the objective of jointly conducting business operations (see Dezshira (2013), 'What is a business cooperation contract (BCC)?', available at: http://www.dezshira.com/faq/answer/what-is-business-cooperation-contract-bcc/22/vietnam).

[99] The case of financial services, which are not physical capital-intensive, is different in several important respects.

1. to maintain strategic policy control;
2. to maximise the rate of service improvements and cost reductions, thereby contributing to decreasing the 'cost of doing business' and improving the country's international competitiveness and FDI-attractiveness;
3. to promote technical progress and technological absorption;
4. to build up a 'nationally-owned' entrepreneurship capability, mainly revolving around one or a few large SOEs in each sector;
5. to enhance the synergies between strategic infrastructural services sectors and other domestic industrial sector;
6. to ensure a high investment rate, channelling domestic resources towards strategic services sectors, attracting FDI from large foreign enterprises, and obtaining funds from official and private lenders;
7. to minimise the capture of quasi-monopolistic rents on the part of foreign TNCs;
8. to ensure the fulfilment of public services and equity-oriented obligations, including the expansion of access for poor and rural population groups.

Such a complex policy approach revolving around a set of diverse, yet ultimately coherent, goals could hardly be carried out in any country due to the relative weakness of the state, both as planner and regulator vis-à-vis powerful TNCs, and its scarce or non-existent role as direct owner and entrepreneur. Conversely, in China planning and regulatory agencies are quite strong, and the state can also rely on large and highly-capitalised SOEs and SCMEs endowed with a relevant (albeit not unrestrained) degree of managerial autonomy.

3.3 *Market socialism: how China sees itself*

The coordination problems raised by the relatively autonomous behaviour of such diverse state agencies and institutions are not trivial. So far China appears to have advanced significantly along a gradual and pragmatic path of coordination, enhancing changes which are always aimed at the ultimate fulfilment of the set of eight key policy goals mentioned above.

China's major economic development achievements, such as the steady and rapid infrastructural and manufacturing expansion and upgrading, the rapid increase in industrial productivity, and the fast speed of economy-wide systemic technical progress,[100] which allowed the country to quickly ascend the global technological ladder[101] in several key

[100] Notwithstanding the persistence of huge spatial gaps in terms of technical advancement and productivity.
[101] China's export structure is more technologically advanced than might be expected given its per capita GDP, a sign that it is performing better than the world average in achieving international competitiveness in high-tech sectors (see UNCTAD 2013b). The core of this argument is not contradicted by the fact that the share of domestic value added in China's exports (while rather high on average) is negatively correlated with the degree of

industries, including telecommunications, renewable energies and next-generation fast ground transportation, would not have been possible without the substantial success of major infrastructure services reforms. In this context, these reforms are to be seen as a key building block of China's market socialist[102] development strategies since the last two decades of the 20th Century.

Box 1: The official adoption of the term 'Socialist Market Economy' by the CPC and its definition

1. The terms 'market socialism' and 'socialist market economy' (which are equivalent and mutually interchangeable) might raise some terminological and methodological ambiguity. In this chapter, they are used mainly for the sake of clarity, based on the fact that they have been officially endorsed by Chinese authorities to characterise their own socioeconomic system. However they are interpreted here as ideologically neutral, and their usage in this chapter does not imply any scientific or value judgment either on the relative weight of market relations or on the effective prevalence of 'truly' socialist features in present-day China on the part of the author.

2. The 14th Central Committee of the Communist Party of China adopted the Decision of the CPC Central Committee on Certain Issues in Establishing a Socialist Market Economy System in its Third Plenary Session, held in Beijing on 11-14 November 1993. Although the market-oriented reform process had already been unfolding since the late 1970s, the Decision conferred the concept of Socialist Market Economy System with the highest theoretical and ideological status. Ten years later, in 2003, the Decision of the CPC Central Committee on Issues Concerning the Improvement of the Socialist Market Economy adopted at the Third Plenary Session of the 16th Central Committee marked the beginning of the 'improvement' phase, and provided direct guidance to the second 10-year reform of the economic system. More recently, speaking in a panel discussion held in the framework of the 18th National Congress of the Communist Party of China (CPC) on 8 November 2012, Li Keqiang (who was about to become China's prime minister) said that 'China should accelerate the improvement of the socialist market economy and facilitate the change of growth model to complete the building of a moderately prosperous society ... Li stressed the importance of keeping to the path of socialism with Chinese characteristics' (Xinhua 2012). A few days after, the full text of the Resolution of the Eighteenth National Congress of the Communist Party of China on the Report of its Seventeenth Central Committee adopted at the Eighteenth National Congress of the Communist Party of China on 14 November 2012 reported that '[t]he

sophistication of each category of exports, a phenomenon common to all developing country manufactured exports.

[102] See Box 1 for the restricted and conventional meaning attached to the term 'market socialism'.

congress emphasised the need to speed up the improvement of the socialist market economy'.[103]*

3. A useful and synthetic definition of how the Chinese define the term socialist market economy was provided recently by the People's Daily: 'The socialist market economy is based on dominant public ownership with co-development of diverse forms of ownership economy it is a market economy based on distribution according to the work as the chief distribution mode with co-existence of a variety of distribution modes; it is a market economy making full use of both means of regulation and market; it is a market economy actively involved in economic globalisation insisting on mutual benefit and win-win opening-up policy.'[104]

*In this key document, as in many others, China's leadership endorses the principle of market socialism, but prefers the theoretically more neutral and patriotic term 'socialism with Chinese characteristics'. In fact, in the Resolution of the Eighteenth National Congress the term market socialism is referred to only once, compared to 19 references to the term 'socialism with Chinese characteristics'.

3.4 *Energy*

Reform processes broadly consistent with the policy lines outlined above have been on-going in all major infrastructure services, with important differences related to the nature and role of each specific sector.

For instance, in the area of energy (and of electrical power in particular), an extremely capital-intensive yet not particularly technologically dynamic sector, the traditional priority for China has been simply the steady and rapid expansion of supply, a necessary condition to keep fuelling its exceptionally fast pace of industrialisation and overall economic growth. For this purpose, large and ever-increasing capital investments were essential.

In this context, as in many others, China's planners were not overly constrained by ideological considerations, and since the 1980s have experimented with innovative public-private ventures. In fact, the first power project implemented under the build-own-transfer (BOT) modality in a developing country was carried out in South China by Hopewell Holdings Ltd., a Hong Kong-based private company.[105]

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[103] See Xinhua (2012), 'Li Keqiang asks for deepening reform', 9 November; CPC (2012), 'Full text of resolution on CPC Central Committee report'.

[104] People's Daily (2012), 'China's Socialist Market Economic Reform and its Strong Theoretical Consciousness and Confidence', October 17.

[105] See Sullivan, J. B. (1990), 'Private power in developing countries: Early experience and a framework for development', *Annual Review of Energy and the Environment*, 15:335 no. 363; Gabriele, A. (2004), 'Policy Alternatives in Reforming Energy Utilities in Developing Countries', *Energy Policy*, 32:11, pp. 1319-1337.

However, China's energy system presented serious deficiencies, the most severe of which related to the excessive complexity of the planning mechanisms and the contradictions between the centre and the provinces. This led the government to implement a series of reforms, an important passage of which was the approval, in 1996, of a new Electricity Law that created the State Power Corporation of China (SPCC) as an entity separate from the Ministry of Electric Power (MOEP). In 2002 the State Electricity Commission was established, with ample regulatory powers.

The reform process continued to advance, as an integral part of the wider restructuring and overhaul of SOEs. Its main goals were: to enhance the system's capacity to generate, trade and effectively deliver power across the whole nation; to attract FDI; to raise productive efficiency and reduce energy waste; and to contain and eventually minimise the negative environmental impact of the energy industry.

These goals have been and are still pursued in a 'context of enhanced – albeit far from exclusive – reliance on the progressive creation of a properly regulated and competitive market for electrical power … Regulation of competitive tendering for plant construction has been introduced, and competition is in fact strong even when confined purely to publicly-owned Chinese firms.'[106]

The ownership regime has undergone progressive changes. Ownership rights were reallocated in order to increase the autonomy of power-generating companies and to create new local generating enterprises. However, state-owned giants still dominate all the main sub-sectors of the energy industry.

Major investment and research efforts have been dedicated to the expansion and renovation of the sector, and especially to the development of renewable energy sources. In this context, a relatively modest contribution has come from FDI in the power generation subsector, but 'transmission and distribution are still heavily controlled by the State.'[107]

3.5 *Finance*

Changes in another key area, financial services, have been numerous as well, but – due to the unique nature of this sector – there has not been a relevant shift in favour of market regulation mechanisms, and the principle of quasi-absolute dominance of public ownership has not been discussed.

[106] Gabriele (2004), p. 14.
[107] Betz, J. (2013), 'The Reform of China's Energy Policies', GIGA Working Papers 216, p. 10.

Arguably, this strategic orientation is correct, given the view that financial activities do not produce any value by themselves, yet are needed to enable the real economy to function. Therefore, and *a fortiori* in a market-socialist context, they are to be seen rather as a public service, similar in many respects to health or education.

In fact, while profits generated by activities belonging to the 'real' part of the economy reflect surplus creation and are needed for investment, accumulation, and growth, there is arguably no social need for financial profits as such. In a capitalist economy, financial profits reflect the capture of part of the overall surplus on the part of financial capitalists and, following the same line of argument, do so without adding anything to the surplus itself.[108]

In the context of a market-socialist economy, the size of financial institutions' profits is, by itself, irrelevant. A minimum level of profits is needed to ensure the sustainability of banks, but it is no more relevant than the profit of a public hospital. In both cases, the public service institution (bank, hospital) shall not be allowed to break the budget constraint, get into debt and go bankrupt, but its goals are very different from those of industrial productive enterprises. The financial health of public banks and hospitals is just a prerequisite to allow them to fulfil their missions: to provide public financial and health services respectively.

Therefore, the central principle guiding financial policies in China is that of maintaining the dominance of public banks, while cautiously exploiting the learning and efficiency-enhancing opportunities that can stem from a synergic interaction with foreign financial institutions, on one hand, and with those of Hong Kong, on the other hand.

As pointed out by the former Chief Executive of the Hong Kong Monetary Authority (HKMA), as China is a 'socialist market economy', the emphasis is clearly on people first; indeed the most important objective of economic development in any jurisdiction is to benefit the

[108] The frenzy to capture financial gains regularly leads to individually rational but systemically unsustainable behaviour on the part of key private actors, thereby provoking financial and economic crises, cyclical recessions, and eventually deep and long-lasting depressions. See Minsky, H. P. (1992), 'The Financial Instability Hypothesis', Working Paper No. 74, The Jerome Levy Economics Institute of Bard College, prepared for *Handbook of Radical Political Economy*, edited by Philip Arestis and Malcolm Sawyer, Edward Elgar: Aldershot, 1993; Bellofiore, R. and P. Ferri (eds), (2001), *Financial Fragility and Investment in the Capitalist Economy:The Economic Legacy of Hyman Minsky*, Volume 2, Hardback 978 1 84064 359; Yellen, J. L. (2009), 'A Minsky Meltdown: Lessons for Central Bankers', Presentation to the 18th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies by the President and CEO, Federal Reserve Bank of San Francisco; Crotty, J. (2007), 'If Financial Market Competition is so Intense, Why are Financial Firm Profits so High? Reflections on the Current 'Golden Age' of Finance', Working Papers wp134, Political Economy Research Institute, University of Massachusetts at Amhert; Crotty, J. (2009), 'Structural causes of the global financial crisis: a critical assessment of the "new financial architecture"', *Cambridge Journal of Economics* 33:4, pp. 563-580; Crotty, J. (2011), 'The Realism of Assumptions Does Matter: Why Keynes-Minsky Theory Must Replace Efficient Market Theory as the Guide to Financial Regulation Policy', UMASS Amherst Economics Working Papers 2011-05, University of Massachusetts Amherst, Department of Economics; Bellofiore, R. (2009), 'L'ipotesi della instabilità finanziaria e il "nuovo" capitalismo', paper presented at the workshop 'The complexity of financial crisis in a long-period perspective: facts, theory and models', Università di Siena, 23-24 March 2009.

people. There is also an emphasis on 'broad-based development', 'co-ordinated development' across geographical areas, and sustainable development'.[109]

Yam therefore argues in favour of the concept of 'scientific development' in finance. The key principle on which this concept is based is that, in China's specific context, the ancillary and instrumental nature of financial development must be more pronounced than in other, structurally different countries:

> The overriding objective of financial development is, of course, achieving effective financial intermediation that promotes economic growth and development ... However, this important objective of effective financial intermediation is often forgotten. The principal objective of the financial intermediaries is to pursue profits, and one way of doing so is to embrace financial innovation, which helps improve financial efficiency, but might also store up troubles that ultimately increase the costs of financial intermediation when financial instability sets in. Sometimes the authorities are to be blamed as well … Learning from the experience of the developed markets, we should also be alert to the possibility of distortions creeping into the incentive system in the financial sector, risking erosion of prudential standards and undermining financial stability. It is also important to bear in mind the possible conflict between the public interest in achieving effective financial intermediation … and the private interests of the financial intermediaries. When conflicts occur, the public interest should always prevail. Although 'finance is the nucleus of a modern economy' its role is to serve the modern economy, not the other way round. Financial development should not take place for its own sake … Here I have to point out the very special characteristic of China that has no precedent elsewhere; that there are two different financial systems under the 'one country, two systems' principle and both are available to serve the financial needs of the country. The mechanism for achieving effective financial intermediation in China must involve exploiting the relative strengths of the two financial systems, addressing their relative weaknesses and maximising the synergies between them. The lack of precedents elsewhere is no excuse for neglecting the unique opportunities for achieving effective financial intermediation.[110]

[109] Yam, J. (2008a), 'The "concept of scientific development" in finance (1)', Hong Kong Monetary Authority.
[110] Yam, J. (2008a), 'The "concept of scientific development" in finance (2)', Hong Kong Monetary Authority.

4. Telecommunications in China: The Tale of an Ever-reforming Industry

4.1 *Telecommunications: the most dynamic infrastructural services sector*

The most striking and interesting example of the Chinese model of reform in strategic infrastructure service sectors is that of telecommunications, the most technology-intensive, fast-growing and rapidly changing of all these sectors.

Telecom markets all over the world, like many others (including all infrastructure services markets) exhibit:

> recognised market failures. Contrary to classical examples of monopoly utility regulation, modern communications and media markets are characterised by two-sidedness and horizontal or vertical links to other markets. The resulting cross-effects of regulation … can be unexpected or at least unintended. A clear understanding of the different forces at work will help to direct future attempts at regulation … In the communications area this will occur with intensifying convergence between different media platforms, regrouping of companies along the value chain, not to mention data protection and privacy issues.[111]

The history of telecom reforms in China is long, complex and ongoing. Numerous valuable studies – some of them focusing on specific subsectors and issues, others of more comprehensive and holistic nature – explore and analyse this history in its many stages and ramifications.[112]

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[111] Cambini, C., S. Hoernig and E. Bohlin (2012), 'Regulation and competition in communications markets', *Telecommunications Policy*, 36:5, pp. 357-359, p. 359; see also Henten, A., R. Tadayoni and J. Whalley (2012), 'Services, regulation and the changing structure of mobile telecommunication markets', *Telecommunications Policy* 36:3, pp. 159-252.

[112] See, among others Li, B., D. Xie and W. Zhu (2005), 'Recent advances on TD-SCDMA in China', *IEEE Communications Magazine*, 2, 30-37; Nickerson J. V. and M. Zur Muehlen (2006), 'The ecology of standards processes: Insights from internet standard making', *MIS Quarterly* 30, pp. 467-488; Vialle, P. (2006a), 'Single technological standard versus multiple competing standards: Analysis of the case of third generation (3G) mobile standards in the European Union and three key Asian markets', IAMOT 2006 Conference, Beijing, China; Vialle (2006b), 'Technological standards, industrial networks and public policy: The case of third generation (3G) mobile telephony in China', 16th International ITS Conference, Beijing, China; Vialle, P. (2007), 'L'emergence de nouveaux acteurs: le cas de la Chine', in P. Vialle (ed), *Mutation des Acteurs, des Ressources et des Activités*. London: Hermes Publishing; Stasik, E. (2010), 'Royalty Rates And Licensing Strategies For Essential Patents On LTE (4G) Telecommunication Standards', *Les Nouvelles:* http://www.investorvillage.com/uploads/82827/files/LESI-Royalty-Rates.pdf; Hsueh, R. (2011a), *China's Regulatory State: A New Strategy for Globalization*, Cornell University Press, Cornell Studies in Political Economy; Hsueh (2011b), 'How China Outsmarted the WTO', RegBlog 12/26/11: https://www.law.upenn.edu/blogs/regblog/2011/12/how-china-outsmarted-the-wto.html; Kshetri, N., P. Palvia and H. Dai (2011), 'Chinese institutions and standardization: The case of government support to domestic third generation cellular standards', *Telecommunications Policy*, 35:5, pp. 399-412: http://dx.doi.org/10.1016/j.telpol.2011.03.005; Vialle, P., J. Song and J. Zhang (2012), 'Competing with

Following WTO accession, China advanced towards the adoption of a western-style telecommunications law and the establishment of an independent regulatory and arbitration agency. In line with its carefully drafted WTO commitments,[113] the government has been gradually opening the carrier market to foreign investors from the US and other countries. As a result, the Chinese telecom industry has changed from an exclusively state-run monopolistic structure to a largely state-run oligopolistic structure.[114] Nowadays, foreign telecommunications operators hold stakes of less than 10 per cent in the internationally-listed subsidiaries of Chinese state-owned operators. Their degrees of business freedom are also constrained by an ever-evolving set of regulations that, albeit WTO-compatible, do contribute to strengthening the competitive hand of domestic enterprises, many of which are SOEs. As a result, for instance, Google and Yahoo were induced to give up some profitable niches in telecom-related services markets.[115]

4.2 *State-led growth and oligopolistic competition*

Crucial goals such as rapid growth and fast technical progress have been achieved,[116] especially in advanced segments of the telecom market.[117] The ratio of Information and Communications Technology (ICT) services exports to total services exports has also been on the rise,[118] a clear indication of China's increasing competitiveness in the area of advanced

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dominant global standards in a catching-up context. The case of mobile standards in China', *Journal of Telecommunications Policy* 36:10-11, p. 6, Pergamon Press, Inc. Tarrytown, NY, USA; Xia, J. (2012), 'Studio interview Beyond iPhone price cut in China', CCTV.com:
http://english.cntv.cn/program/china24/20120904/102301.shtml

[113] After very long and tough negotiations China finally joined the WTO in 2001. According to Hsueh (2011), China's negotiators and policy-makers were shrewd enough to actually 'outsmart the WTO'. In my view, this is a gross and disingenuous overstatement. The access conditions imposed on China by its WTO partners were in fact very onerous by historical standards, and the outcome of the negotiations simply reflected the objective relation of forces, taking into account the basic fact that by the late 1990s China was already a very strong and autonomous player in the global trade arena.

[114] See Table 1. In the mobile phone subsector, for instance, there are three state-owned operators (China Mobile, China Unicom, and China Telecom). Their estimated respective market shares by early 2013 were 66%, 20%, and 14% (see Laperrouza, M. (2008), 'Regulatory Reform in China's Telecommunication Sector: A Case of Policy Transfer Failure or of Policy Divergence?', PPP, CPRsouth3 – Beijing, China, Transformation Strategies for Telecom Operators, December 5-9, 2008, High-Tech Mansion of BUPT, Beijing, China; OnBile (2013), 'China mobile market share'). In November 2011, the government initiated an investigation of China Telecom and China Unicom for monopolistic practices in national broadband pricing, with the main goal of maintaining and better regulating a moderate degree of competition among main players (see China Telecom (2012), 'Annual Work Conference Highlights').

[115] See Hsueh (2011b).

[116] On the quest for innovation in China's market socialist context see Gabriele (2001) and (2002).

[117] See Table 1 and Graphs 1, 2 and 3. China's telecom development has been extraordinary if seen in absolute terms. Progress has also been substantial in relative terms, yet is considerably less impressive. Vietnam, for instance, has expanded the rate of mobile cellular subscriptions at a faster rate than China.

[118] See Graph 4.

electronic technologies, consistent with the overall evolution of the country's export structure as a whole.[119]

By March 2012, China had reached 284 million fixed-line subscribers and over one billion mobile customers, converting its telecom market into the world's largest. New technologies are being developed, among them asymmetric digital subscriber line (ADSL), wireless local area network (WLAN), internet protocol (IP) telephony and services associated with mobile communications, such as short message services (SMS) and multimedia messaging services (MMS).[120] Such achievements are unique, taking into account the sheer size of China compared to the rest of the world and its relative technological backwardness in the telecom sector in particular, that was still very marked until the end of the last millennium. This is shown, for instance, by the extremely low rate of mobile phone subscribers.[121] The strongly state-led development of mobile telecommunications has also contributed to reducing China's digital divide,[122] one of the many dimensions of overall social and geography-based inequality.

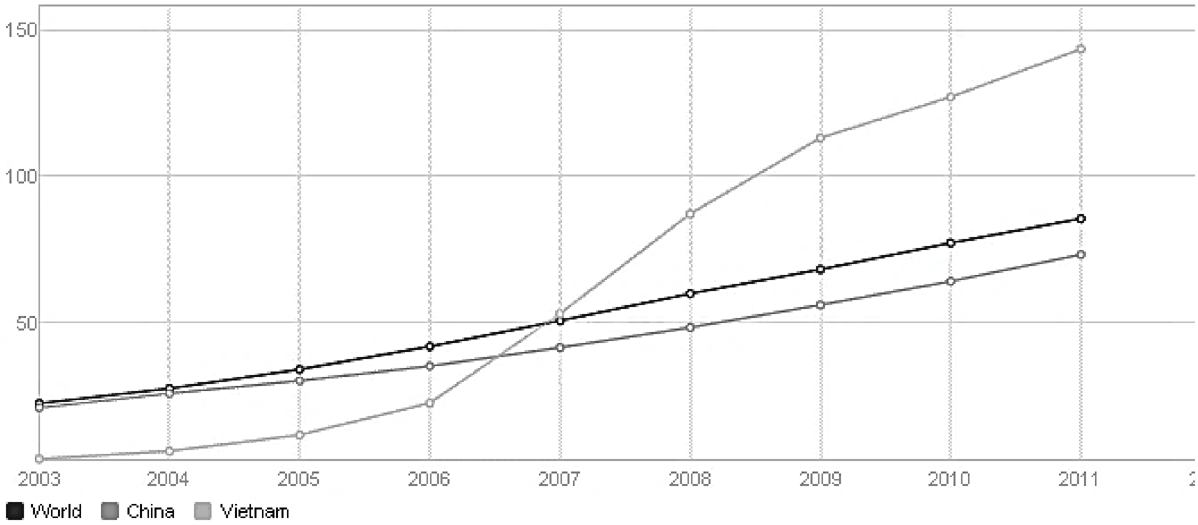
Table 1: Herfindahl-Hirschman Index (HHI) for Chinese mobile operators, 1994-2008

Market Share (%)								
	1994	**1995**	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**
China Mobile	100	95	78	65	66	67	69	72
China Unicom	0	5	22	35	34	33	31	21
China Telecom	0	0	0	0	0	0	0	7
HHI	1000	8961	6550	5440	5512	5578	5722	5602

Source: Laperrouza (2008).

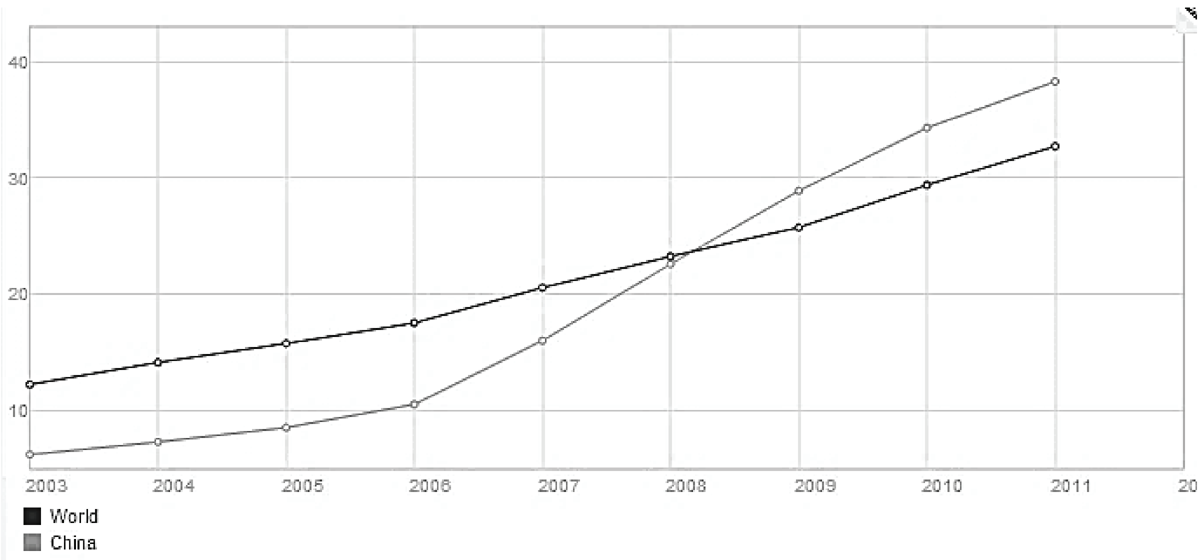
[119] See UNCTAD (2013b), 'Key Trends in International Merchandise Trade', UNCTAD/DITC/TAB/2013/1.
[120] Wu, I. S. (2009), 'From iron fist to invisible hand: the uneven path of telecommunications reform in China', Stanford University Press, Stanford, CA978-0-8047-5962-5; China Telecom (2012).
[121] See Graph 1.
[122] The digital divide in China had been widening when only fixed-line telecommunication services were available, and kept doing so in the early era of mobile telecommunications. Yet, it began narrowing from the mid-2000s, after huge investment in mobile telecommunications network development were carried out in relatively poorer regions as part of the Go West drive, thereby showing that 'proactive government policies are still crucial in ensuring that the digital divide does not further widen as growth and development take place' (Loo, B. P. Y. and Y. L. Ngan (2012), 'Developing mobile telecommunications to narrow digital divide in developing countries? Some lessons from China', *Telecommunications Policy* 36, pp. 888-900, p. 899).

Graph 1: Mobile cellular subscriptions (per 100 people)



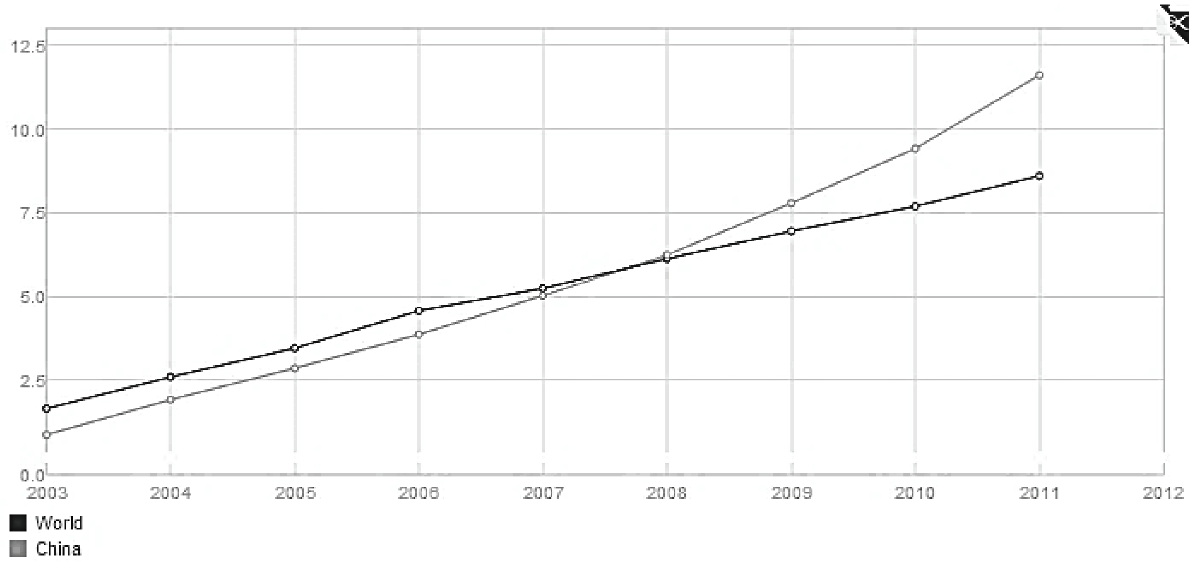
Source: WB-WDI

Graph 2: Internet users (per 100 people)



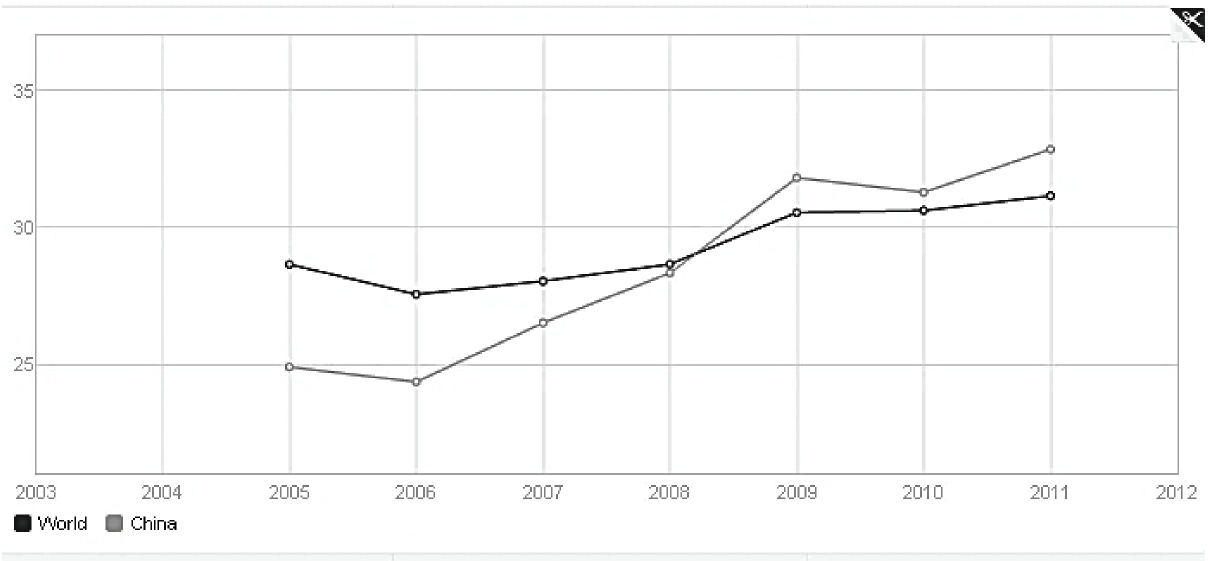
Source: WB-WDI

Graph 3: Fixed broadband internet subscribers (per 100 people)



Source: WB-WDI

Graph 4: ICT service exports (% of service exports, BoP)



Source: WB-WDI

4.3 *A qualified success*

Striving constantly to achieve multiple and partly conflicting goals in an extremely complex ownership, legal and institutional context, and to exploit the enormous potential economies of scale and scope stemming from the size of its domestic market and the unique remarkable planning and investment power of the state, China has been able to foster national champions with international strategies, to introduce relatively advanced IPR legislation, and to foster an extremely fast development of the telecom sector as a whole and indigenous mobile standards.[123] Yet, the result of such a complex,[124] dynamic, and intrinsically 'dialectic'[125] process cannot be expected to be flawless. Areas of partial failure[126] are also part of the picture. The most notable is probably the uncertain outcomes of the multiple initiatives aimed at promoting national mobile technical standards, which implied a composite 'co-evolution process between firm strategy and government policy aimed mainly at solving the challenges of late-comer disadvantages'.[127] Such a qualified success is best interpreted through the lens of an institution-centred analytical approach that recognises that, along with explicit regulative processes (such as rule setting, monitoring and sanctioning activities), implicit and informal regulatory processes stemming from inter-institutional interaction are also at work.[128]

Among other policy tools, export credit and other forms of preferential financing by state-owned banks support the global purchase of telecommunications equipment produced by Chinese companies, such as Huawei and ZTE.[129] In telecommunications value-added services, existing licensing and joint venture requirement rules have been reinforced and other new regulations have been introduced since the mid-2000s with the joint goals of softly supervising the business of information dissemination and boosting the technological development and the competitive position of Chinese enterprises.[130]

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[123] See China IPR (2013), 'Big Increase in Administrative Patent Infringement Cases in 2012'.

[124] Yu et al see China as representative of a limited class of large developing countries, arguing that 'facing high uncertainties in future technology trajectories, these countries may follow both mission-orientation and diffusion-orientation paradigms in technology development' (Yu, J., Y. Zhang and P. Ghao (2012), 'Examining China's technology policies for wireless broadband infrastructure', *Telecommunications Policy* 36, pp. 847-857, p. 847).

[125] Here, the term 'dialectic' is used metaphorically, to refer to the continuous and often conflicting interaction of different forces.

[126] One of them is actually the multiple initiatives aimed at promoting national mobile technical standards. See Vialle et al. (2012).

[127] Gao X. and J. Liu (2012), 'Catching up through the development of technology standard: The case of TD-SCDMA in China' (Reprint), *Telecommunications Policy* 36:10-11, pp. 817-831, p. 817.

[128] See Laperrouza (2008); Hsueh (2011a), (2011b); Xia (2012).

[129] Huawei is an employee-owned private company. It is the largest telecommunications equipment-maker in the world. ZTE was founded in 1985 by a group of state-owned enterprises associated with China's Ministry of Aerospace. It is the world's fourth-largest mobile phone manufacturer measured by 2012 unit sales and the world's fifth-largest telecoms equipment maker measured by 2012 revenues (see ZTE (2013), 'ZTE 2012 Annual Report').

[130] See Tan, Z. (2002), 'Product cycle, Wintelism, and cross-national production networks for developing countries: China's telecom manufacturing industry as a case', *info* 4:3, pp. 57-65.

4.4 *The challenge of long-term planning*

China's telecom development strategy was not the product of a relatively simple profit-maximising exercise on the part of a private firm,[131] but the result of a long-term planning process. This process, albeit strongly centralised, could only be carried out through a progressively evolving network of formal and informal, market and non-market interactions among a large number of national (mostly state-owned), foreign (such as TNCs and OECD governments) and multilateral actors (such as international institutions like the WTO and the ITU). Even China's 'state' itself is only a single, easily identified actor in theory. In practice, it is a mosaic composed of a myriad of institutions and organisations (such as SOEs), all endowed with a non-zero degree of autonomy and run by directors, managers and workers, whose behaviour is affected by complex and uneven structures of formal and informal incentives. State institutions - such as SASAC, the Ministry of Industry and Information Technology (MIIT),[132] the National Development and Reform Commission (NDRC)[133] - and organisations, are not homogenous, and can in practice pursue diverging interests. Tensions can arise between planners' objectives and actual SOEs' behaviour.[134]

Moreover, the difficulty of this multi-pronged planning process was magnified by the attempt to optimise the industry's long-term catching-up and development path under conditions of limited information availability and uncertainty. Besides other problems, this attempt inevitably implied significant inter-temporal trade-offs between short- and long-term goals and (at crucial stages of the reform process) the inescapable need to gamble between alternative strategic choices, the risks and potential benefits of which could only tentatively be gauged.

A particularly interesting example of this type of problem, and of the difficulty of unambiguously evaluating ultimate welfare implications, is offered by the tendency towards overinvestment. This tendency is widespread in China's economy as whole, and is particularly strong in the telecommunications sector. A recent econometric study shows a positive correlation between mobile market concentration and mobile network investment in the industry, and interprets its finding as a product of 'the soft budget constraint problem that occurs under asymmetric market competition between state-owned enterprises.'[135] According to the authors, the ultimate result is wasteful overinvestment.

[131] 'state priorities come ahead of shareholders' profits for Chinese Telecommunications companies' (Kshetri et al (2011), p. 407).
[132] The MIIT regulates telecommunications and oversees manufacturing industries.
[133] The NDRC is in charge of ensuring economic stability and growth.
[134] See Xia (2012); Vialle et al. (2012).
135Kang, F., J. Hauge and T. Lu (2011), 'Competition and Mobile Network Investment in China's Telecommunications Industry' TPRC September 24. Kang, M. (2006), 'Subsidy Policy of China, Japan and Korea under the WTO: Implications of an FTA among Three Countries', Research Gate.

In the view of this author, however, more caution should be exercised in evaluating the ultimate welfare implications of such a powerful investment drive, as it might be possible that what looks to be overinvestment in the short- or even medium-term, ends up being an effective (albeit suboptimal) mechanism to channel large resources towards a technologically-intensive and very strategic sector in the long-term, eventually generating more benefits than costs.

Last, but not least, it may be worth remembering that in the area of telecom reform, as in many others, China's experience has been and still is unparalleled, both because China is so particular in many respects, and because planners and experts do not have any meaningfully comparable historical precedents to learn from.

5. OECD Principles on SOEs' Governance and Competitive Behaviour and the Reality of China's Public Enterprises

5.1 *The OECD Guidelines on Corporate Governance of State-Owned Enterprises*

The OECD synthesised the results of many years of research and advocacy of free-market principles in a mid-2000s report focusing on state-owned enterprises,[136] formulating a series of guidelines that are supposed to guide their governance (the OECD Guidelines on Corporate Governance of State-Owned Enterprises).[137] This sub-section presents and briefly discusses some of the basic tenets of this important document.

In the Foreword, the OECD observes that 'until now, there has not been any international benchmark to help governments assess and improve the way they exercise ownership of these enterprises, which often constitute a significant share of the economy. These OECD Guidelines on Corporate Governance of State-Owned Enterprises fill this important gap.'[138]

Within these Guidelines, the OECD acknowledges that SOEs bear obvious similarities with private firms, but also important differences. Therefore, on one hand, 'the state can benefit

[136] Throughout the Guidelines, the term 'SOEs' refers to enterprises where the state has significant control, through full, majority or significant minority ownership. In the terminology of China's official statistical sources, the extensive coverage of this term would correspond to the term SOSHEs (State and State-Holding Enterprises). For the sake of simplicity and clarity, in this sub-section, as well as in the remainder of this chapter, the term SOE will be used extensively, in the same fashion as in OECD (2005), to also refer to China's public firms.

[137] The Guidelines on Corporate Governance of State-Owned Enterprises, by their very nature, are not a binding legal instrument containing rules that all OECD members must always respect in the context of their real-life policy making. They consistently contain the following disclaimer: 'The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.'

[138] OECD (2005), 'OECD Guidelines on Corporate Governance of State-Owned Enterprises'**:** http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf**, p.** 3.

from using tools that are applicable to the private sector, including the OECD Principles of Corporate Governance.'[139] On the other hand:

> SOEs also face some distinct governance challenges. One is that SOEs may suffer just as much from undue hands-on and politically motivated ownership interference as from totally passive or distant ownership by the state … the rationale for state ownership of commercial enterprises has varied among countries and industries and has typically comprised a mix of social, economic and strategic interests[140]

in areas such as industrial policy, regional development, the supply of public goods and natural monopolies. Since the last quarter of the past century, phenomena such as the acceleration of globalisation, technological changes and the widespread deregulation of previously monopolistic markets have required various forms of SOE readjustment and restructuring.

As experience shows that 'to reform corporate governance of state-owned enterprises is … an important but also complex undertaking', policy-makers must strive to 'to find a balance between the state's responsibility for actively exercising its ownership functions, such as the nomination and election of the board, while at the same time refraining from imposing undue political interference in the management of the company.'[141]

It is interesting to note that the first, paramount, and relatively surprising (in a time when shallow celebrations of the supposedly self-coordinating virtues of extreme decentralisation and unbridled federalism are common) policy suggestion put forward in the Guidelines refers to centralisation: 'the state should exercise its ownership functions through a centralised ownership entity, or effectively coordinated entities, which should act independently and in accordance with a publicly disclosed ownership policy.'[142] In this context, the Guidelines advise that the government should develop an ownership policy that defines, clarifies and prioritises its objectives.

Such a strong emphasis on centralisation is welcome, as it fully consistent with the primary purpose of SOEs, which should be seen first and foremost as tools that the state can use in a planning framework.

The Guidelines also argue in favour of a strict separation of the state's ownership and regulatory functions, allowing SOEs full operational autonomy under the management of their governing boards. This second suggestion, far from being seen as contradictory with

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[139] OECD (2005), p. 10. See also OECD (2004), 'OECD Principles of Corporate Governance': http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.

[140] OECD, p. 10.

[141] OECD, p. 3.

[142] OECD, p. 3.

respect to the first one, is in fact quite consistent with it. A clear functional separation of different state bodies is a necessary condition for effective state planning, taking into account that any state is in fact a network of several bodies interacting with each other in a non-market fashion. In turn, these bodies are made up of thousands of individuals who cannot be naively expected to maximise the common good simply thanks to high ethical principles, but behave according to their own incentive structure. In this context, the separation of ownership and regulatory functions can go a long way towards minimising the ever-present risk of capture of public assets on the part of corrupt or opportunistic officers (often acting as tools of powerful private interests), and can help to design an effective overall incentive structure.

The OECD also recommends that the state ensures 'that there is a level playing field in markets where private sector companies can compete with state-owned enterprises and that governments do not distort competition in the way they use their regulatory or supervisory powers.'[143] Full administrative separation of responsibilities for ownership and market regulation is a fundamental prerequisite for creating such a level playing field.[144]

Consistently, it is important to ensure that SOEs operate within an effective legal and regulatory framework. In particular, 'any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations',[145] and be transparent and accessible to the public. Sufficient flexibility should also be allowed for adjustments in the capital structure.

The Guidelines also stress that 'general procurement rules should apply to SOEs as well as to any other companies.'[146] Moreover, 'SOEs should face competitive conditions regarding access to finance. Their relations with state-owned banks, state-owned financial institutions and other state-owned companies should be based on purely commercial grounds.' These recommendations are consistent with the rest of the OECD arguments, yet are clearly divergent from the practice of most countries, including China. A rigid interpretation of this suggestion would imply, on the part of the state, a pre-emptive renunciation of the possibility of using non-market forms of coordination among different public entities (including SOEs, banks, and ministries) in order to pursue intrinsically legitimate planning goals.

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[143] OECD, p. 3.

[144] However, the Guidelines appear to warn against an excessively rigid interpretation of their own recommendation, arguing that 'such separation does not prevent necessary co-ordination between the two functions' (p. 19).

[145] OECD, p. 12.

[146] OECD, p. 19.

5.2 *Competitive neutrality*

The concept of competitive neutrality (CN) has been pioneered by the OECD, and can be seen as a consistent development of its ongoing work on the governance of SOEs. One of the earliest and most synthetic definitions of competitive neutrality is presented in a document that was originally produced to record the proceedings of two roundtables on i) the Application of Antitrust Law to State-Owned Enterprises, and ii) Corporate Governance and the Principle of Competitive Neutrality, held by the Competition Committee (Working Party No. 3 on Co-operation and Enforcement) in October 2009:

> CN [is a] regulatory framework (i) within which public and private enterprises face the same set of rules and (ii) where no contact with the state brings competitive advantage to any market participant.[147]

Three other complementary and authoritative definitions of CN have been proposed by Deborah Healey and the government of Australia – a country that has pioneered legislation in this area – and by the OECD itself:

> CN is the recognition that significant government business activities which are in competition with the private sector should not have a competitive advantage or disadvantage simply by virtue of government ownership and control. Competitive neutrality policy involves analysis and implementation of steps to ensure that this advantage does not occur.
>
> CN requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership.[148]
>
> CN neutrality occurs where no entity operating in an economic market is subject to undue competitive advantages or disadvantages.[149]

CN policy involves analysis and implementation of steps to ensure that the above-mentioned 'unfair' advantage of government business activities does not occur. In this respect, it has to be pointed out that competition laws (the most direct policy tool that are commonly enacted to ensure competition among private firms), prevent overt anticompetitive conduct but, as a general rule, do not by themselves guarantee a level playing field for competition between

[147] OECD (2010), 'State-owned Enterprises and the Principle of Competitive Neutrality', Directorate for Financial and Enterprise Affairs Competition Committee, DAF/COMP(2009)37, p. 11.

[148] Capobianco, A. and H. Christiansen (2011), 'Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options', OECD Corporate Governance Working Papers, No. 1, OECD Publishing, p. 5, Box 1.

[149] OECD (2012), 'Competitive Neutrality – A Compendium of OECD Recommendations, Guidelines and Best Practices', p. 13.

state-owned enterprises, state-controlled enterprises, other government businesses and private enterprises.[150] However, the *ex ante* implementation of a suitably targeted CN framework (as has happened, for instance, in Australia since the 1990s) can favour the practical realisation of the CN principle. Additional ways to ensure that SOEs are not advantaged over private enterprises can include privatisation, effective governance, enhanced independence, accountability and disclosure,[151] and the implementation of pro-competitive norms such as EU Art 86.[152]

CN is not a panacea. In particular, it is not appropriate in cases where it hampers the achievement of (clearly and transparently identified and determined and circumscribed) important societal goals. This might be the case, for instance, where an SOE is given the mandate to monopolistically manufacture and distribute a life-saving drug, thereby socialising the benefits stemming from high economies of scale and avoiding the emergence of artificial scarcity and private rents.

As a general rule, CN is clearly not appropriate where:
1. goals are chiefly social in nature (as it is the case, for instance, for health services);
2. direct non-market provision of services is optimal due mainly to the combination of economic and social factors, such as economies of scale, equity/equality considerations, and the goal of universal access according to basically uniform standards.

However, in some non-social domains, markets (and sub-markets) do exist where monopoly is the most efficient form of supplying a service or a good. This can be true due to the existence of natural monopolies, but not exclusively. In some markets, due to various factors – including the state of technology, the characteristics of the demand structure, and the limited capability and autonomy of regulatory authorities (implying a risk of regulatory capture on the part of colluded private oligopolists) – competition according to CN rules can be feasible but suboptimal.[153]

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[150] Competition law is neither a necessary nor a sufficient condition for competitive neutrality. On the one hand, competition laws usually prevent overt anticompetitive conduct on the part of enterprises, but do not regulate the behaviour of third parties (such as the government itself), and therefore they do not necessarily ensure a level playing field for competition between government businesses and private enterprises. On the other hand, competitive neutrality might obtain de facto in a given industry even in the absence of competition law, if the government implicitly or explicitly allows the enterprises it owns or controls a very high degree of autonomy, does not instruct their managers to pursue non-profit related goals, and abstains from supporting them selectively through financial and/or regulatory forms of preferential treatment.

[151] Outward privatisation could also (paradoxically) be seen as a final solution to the problem of SOEs enjoying 'unfair' advantages over private firms.

[152] See EU (2013), Article 86 of the EC Treaty (ex Article 90).

[153] Some of these arguments resemble others that have been advanced to provide rationales for public ownership, apart from pursuing non-commercial, social activities (see Christiansen, H. (2013), 'Balancing Commercial and Non-commercial Priorities of State-Owned Enterprises', OECD Corporate Governance Working Papers, No. 6, OECD Publishing). It is, however, important to distinguish between the arguments in favour and against the existence of SOEs *per se* and those concerning whether or not they should operate under a competitive neutrality regime under different circumstances.

Moreover, delicate trade-offs do manifest themselves even in other areas, especially when long-term, development-related planning goals are taken into account. In some cases the application of CN rules might be optimal in the short- to medium-term, yet incompatible with the establishment of one or more SOEs that can act as technological pioneers, according to the traditional infant industry principle and/or to long-term strategic considerations aimed at accelerating the path of technological progress as a means to enhance economic and social development. A high degree of risk and uncertainty, and very complex inter-temporal game theory evaluations are involved in this kind of policy choice. As a matter of fact, not only are future states of the world difficult to forecast, but they also depend on each actor's own choices (such as, for instance, to set up an SOE or not) and on other actors' strategic responses (how would, for instance, incumbent TNCs or even powerful domestically-owned private enterprises react?) and on the interplay of each actors' expectations.

For instance, presently oligopolistic or even monopolistic markets might in fact be at least potentially contestable.[154] In that case, not only the future, but even the present behaviour of private incumbents is bound to be affected by the mere probability that a state-controlled competitor might be set up some time from now, and also by the incumbents' expectations about the regulatory framework that will eventually prevail (e.g. whether or not the framework will be fully or partly consistent with CN principles).

However, beyond such relatively clear-cut situations, a grey area does exist, where less well-specified, yet legitimate, industrial policy-related and developmental goals may require a less-than-full implementation of the CN framework.

5.3 *Do China's SOEs follow OECD's prescriptions?*

In the area of strategic infrastructure services, within the telecom sector in particular, Chinese SOEs (which are increasingly being listed) by and large tend to follow OECD guidelines on SOE governance. Conversely, the government has purposefully chosen so far to follow some, but not all, the prescriptions regarding the CN network put forward by the OECD.[155] According to the preliminary findings of the Competitive Neutrality UNCTAD Research Partnership Platform (RPP) project,[156] the most important policy tools implemented by the Chinese state to strengthen its SOEs and/or induce them to adopt behaviour consistent with overall planning goals are identified as preferential fiscal and credit conditions, easier and cheaper access to land and other natural resources, and, more broadly, an array of other forms of

[154] See Baumol, W. J., J. C. Panzar and R. D. Willig (1982), *Contestable Markets and the Theory of Industry Structure*; Martin S. (2000), *The Theory of Contestable Markets*, Purdue University.

[155] Of course, China has no formal obligation to follow these recommendations, as they are not legally binding. Moreover, China is not even an OECD member.

[156] Presented by CN project leader, Deborah Healey, at the 5th meeting of the UNCTAD RPP, held in Geneva on 7 July 2013.

‘policy support.’[157] SOE managers also usually have the advantage of maintaining direct personal relationships with government officials, although their enterprises are often burdened with broader corporate social responsibilities and public welfare-oriented functions with respect to other firms. According to many observers, China’s much-improved legal framework in the area of public procurement also leaves significant policy space for both direct and indirect (i.e. cross-enterprise) forms of support to SOEs, from both the demand and the supply side.[158] More broadly, public procurement also constitutes an effective industrial policy and regulatory tool.[159]

Moreover, the spectacular success of China’s National System of Innovation – increasingly based on the promotion of cooperation between universities, research centres and enterprises, and on the strengthening of enterprises’ own R&D and innovation capabilities – disproportionally benefits strategic sectors (among them IT, aeronautics, high-speed trains, energy and nanotechnologies) in which large SOEs are dominant players.[160] Compared to other Asian countries such as Japan or Korea, China also has a particularly high share of total subsidies earmarked for R&D, and thus mainly – for the same reason mentioned above – for technologically advanced SOEs.[161]

More controversially, some observers argue that China de facto selectively applies entry limitations and other forms of non-unrestricted application of the national treatment principle to foreign-owned TNCs in telecom and other strategic markets. For instance, Hsueh maintains that the real goal of recent policy measures to manage competition among state-owned telecom operators and to implement TD-SCDMA was to resolve ‘interdepartmental disputes between incumbents and new entrants,’ rather than ‘a genuine attempt to ensure a truly level playing field or decrease tariffs for consumers.’ She also contends that ‘today foreign telecommunications operators do not operate independently in China and hold less than 10 per cent stakes in the internationally listed subsidiaries of Chinese state-owned operators … new regulations since the mid-2000s encroach on the business scope of foreign

[157] Since 2007, direct subsidisation of SOEs is more restricted than in the past, and is applied only for sectoral or other specific reasons.

[158] See Rothery, R. (2003), ‘China’s Legal Framework for Public Procurement’, *Journal of Public Procurement* 3:3, pp. 370-388; Capobianco, C. (2011); Lenhart, J. and K. Sullivan (2012), ‘Navigating China’s Government Procurement Market’ chinabusinessreview October 1; Healey (2013).

[159] According to China’s contribution to UNCTAD’s ‘Intergovernmental Group of Experts on Competition Law and Policy’, ‘in some regulated industries (such as railway, customs, bank, etc.) the government procurement is operating a vertical intra-industry regulatory system’ (Fang, X. (2012), ‘The status and prospect of Chinese public procurement system – from the perspective of competition law’, written contribution from China to the Intergovernmental Group of Experts on Competition Law and Policy, UNCTAD, Geneva, 9-11 July 2012, Roundtable on ‘Competition Policy and Public Procurement’, pp. 2-3.

[160] See Xu, Y. and M. Gong (2003), ‘National Innovation System and its Implications for 3G Development in China’, *Communications and Strategies* 52; Gabriele and Khan (2010); Fabre, G. and S. Grumbach (2012), ‘The World upside down: China's R&D and innovation strategy’, WP-2012-07, no. 7, Fondation Maison des sciences de l’homme, 190 avenue de France, 75013 Paris, France.

[161] See Kang, M. (2006), ‘Subsidy Policy of China, Japan and Korea under the WTO: Implications of an FTA among Three Countries’, Research Gate.

companies and enforce previously unobserved licensure rules, such as a joint venture requirement.'[162]

Hsueh's wording is quite polemic. Yet, from a factual viewpoint, her views are basically consistent with the analysis carried out above. It is nevertheless puzzling that she appears to be outraged by the fact that the Chinese state does not accord a high priority to objectives such as ensuring a truly level playing field or decreasing tariffs for consumers. In fact, there is nothing strange about that. On the contrary, it should be seen as self-evident, and of course commendable, that the Chinese state attaches the highest priority not to the short-term interests of (domestic or foreign) suppliers or consumers, but to the long-term economic, technological and social development of the country as a whole.

Actually, it is fair to acknowledge that, with some exceptions, China's degree of compliance with OECD-sanctioned competitive neutrality principles is far from complete, yet it is often higher than the minimum standard negotiated during China's WTO accession. As in the case of tariff-related and other commitments in the areas of trade in goods and services, China's applied policies are WTO-compatible, yet maintain a prudential policy space that could allow the government to adopt a relatively more protectionist stance in case of necessity, while still not violating its WTO commitments. The same argument, of course, applies by and large to China's binding commitments adopted in the frameworks of numerous other bilateral, regional and multilateral trade agreements.[163]

5.4 *A provisional synthesis*

What kind of (provisional) synthesis can be made of the diverse arguments briefly sketched out in this section? Essentially, so far, the above-mentioned policy stance on the role of SOEs and the CN framework has served China well. As a matter of fact, China's policy course with respect to CN in particular is appropriate for a country with three key characteristics. China is a developing country; it has a relatively sophisticated export structure, i.e. technologically advanced products represent a relatively high share of the country's total s exports (see Appendix), showing indirectly that China is effectively engaged in a research-intensive catching up process aimed at accelerating technological progress, and at enhancing indigenous innovation capability; and it constitutes a quasi-unique form of socioeconomic

[162] Hsueh (2011b).

[163] Some of China's trade partners, and the US in particular, have advocated in favour of a change in China's policy stance on the role of SOEs and on the issue of CN in particular (see Davis, B. (2011), 'Hormats Challenges "Distorted" Advantages for China's State Firms', *The Wall Street Journal*, November 25; USCBC (2012), 'US-China Business Council Board of Directors Statement of Priorities in the US-China Commercial Relationship – Ensure Competitive Neutrality and Improve Transparency'; USBC (2013a), 'US-China Business Council, State Asset Supervision and Administration Commission (SASAC)', Update: 11 June 2013; USCBC (2013b), 'An Introduction to the US-China Business Council'.

formation based on a specific form of market socialism that distinguishes it systemically from most other countries and intrinsically implies a relatively higher degree of planning and state intervention in the economy (both actual and potential), using a vast array of institutional, organisational, policy and regulatory tools, among which SOEs and SCMEs are prominent.

China is already progressively refining its regulatory framework, in order to promote the emergence of more competitive and efficient forms of market competition in a number of areas where the government considers such a policy course to be consistent with the country's development strategy. According to specific circumstances and sectoral characteristics, policy-makers might be promoting competition for the sake of reaping benefits stemming from the intrinsic merits of competition per se, and/or because a certain degree of further market opening is seen as a bargaining chip useful for negotiating with developed countries' TNCs and governments.

Nevertheless, taking account especially of characteristics ii) and iii) identified above, China's overall development strategy would not be boosted if the country had to commit in a binding form to implement a comprehensive CN framework in the context of WTO or other trade negotiation fora.

6. Reforms in Strategic Infrastructural Services Sectors as a Key Element of Market-socialist Socioeconomic Formations: A Long-term Systemic Interpretation

6.1 *China as a market-socialist socio-economic formation*

The preceding sections have focused on the identification and analysis of the main features of China's policy approach to reforming strategic infrastructure service sectors. The present section proposes an interpretation[164] of this policy approach as one of the most relevant manifestations of the structural nature of China's socioeconomic system.

At its core, this interpretation is based on the following proposition: China's distinct economy and social fabric can be seen as a concrete historical example of the theoretical possibility of the existence of structurally different market-socialist socio-economic formations

[164] This interpretation, in turn, rests on a set of admittedly debatable theoretical categories and classification criteria that are summarily sketched out below.

(MSSEFs),[165] in an era where global market mechanisms govern most international economic relations and the bulk of production and exchange relations.[166]
The only other MSSEF existing so far is Vietnam. As China and Vietnam share this distinctive structure, it is to be expected that they might also have followed similar approaches in the domain of infrastructure services, and of the key telecom sector in particular. This has in fact been the case, as shown in the following sub-section, which summarises the main tenets of the gradual liberalisation of the telecommunications sector in Vietnam.

6.2 *Vietnam: a brief comparative note*

The structure of the Vietnamese telecommunications sector is on the one hand complex, as there are numerous players, and on the other hand simple, as the government is still fundamentally in control.

Until the mid-1990s the state-owned Vietnam Post and Telecommunications Corporation (VNPT) – an arm of the Ministry of Post, Telecommunications and Information Technology (DGPT) – operated in what was effectively a fully monopolistic market, both in the domain of services provision and in that of infrastructure development.

In 1996, a process to promote limited internal competition in the telecommunications sector began when operating licenses were issued to the Saigon Post and Telecommunications Services Corporation, a joint stock company in which VNPT held a large share of the equity. Next, operating licenses were issued to Vietel, the army's telecommunications company, the Vietnam Maritime Communications and Electronics Company (VISHIPEL), and the Electric Telecommunications Company (ETC).

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[165] A socio-economic formation is the specific complex of social relations of production and exchange obtaining in a certain country or group of countries during a long period of time. The term 'socioeconomic formation' was introduced by Marx. The focus on the evolution and change (including, in some cases, of a revolutionary nature) of socioeconomic relations and structures in a very long-term perspective is a key feature of the Marxian cultural tradition, as well as of other schools of thought that present major divergences with respect to Marxism, among them the French Annales School of historical writing and the multiple interdisciplinary forms of structuralism (see Marx (1859), *A Contribution to the Critique of Political Economy*; Marx, K. (1867), 'Preface to Capital, Vol I', (German edition) in Marx and Engels, *Collected Works*, Vol. 35; Braudel, F. (1950), 'Pour une économie historique', *Revue économique* 1: 1, pp. 37-44; Braudel, F. (1997), *Civilisation matérielle, économie et capitalisme, XVe-XVIIIe siècle*, Armand Colin, ISBN-10: 2200371020; Wallerstein, I. (1991), 'Braudel on Capitalism, or Everything Upside Down', *Journal of Modern History* 63:2,pp. 354-361; Skidmore, T. E. (2003), 'Levi-Strauss, Braudel and Brazil: a Case of Mutual Influence', *Bulletin of Latin American Research* 22:3, pp. 340-349; Dutt, A. K. and J. Ros (2003), *Development Economics and Structuralist Macroeconomics: Essays in honor of Lance Taylor*, Edward Elgar.
[166] See Gabriele, A. and F. Schettino (2012), 'Market Socialism as a Distinct Socioeconomic Formation Internal to the Modern Mode of Production', *New Proposals: Journal of Marxism and Interdisciplinary Inquiry* 5:2, pp. 20-50.

Subsequently, in 2003, DGPT split into two: a body governing the post system as such and another supervising the telecommunications and information sector proper.

However, DGPT substantially retains the ability to vet foreign purchase agreements and network structures, and to issue operating licenses. VNPT is still the dominant player in the telecommunications market. VNPT also controls, either directly or via equity arrangements and joint ventures, over 200 subsidiary companies, active in the areas of equipment manufacturing and sourcing, and in a number of support services such as R&D, infrastructure construction, fixed-line installation and transportation. As a result, Vietnam's telecommunications sector has a very high degree of vertical integration.[167]

With respect to policy initiatives, apart from the implications of the commitments taken in the framework of the US-Vietnam and the 2006 WTO accession, the most important recent policy measure was the Ordinance on Posts and Telecommunications No. 43, issued in 2002, which formally established the legal conditions for the development of a competitive market in telecommunications services. The Ordinance distinguished among three different types of telecommunications networks and enterprises. Public networks providing services to the public at large are the only ones allowed to set up international communication networks, and may only be established by Vietnamese telecommunications enterprises. Private networks provide services to a limited group of users. Telecommunications enterprises (all of which must obtain licenses) are either Network Infrastructure Providers (NIPs) or Service Providers (SPs). Only NIPs, which must be SOEs or state-holding enterprises[168] may supply all categories of telecommunications services, and may set up the necessary network infrastructure. The Ordinance also mandated an open interconnection regime, to which all operators could connect in 'fair and equitable' conditions, supervised by a regulator.

Vietnam has committed to a fairly high degree of liberalisation and opening up to international trade in the telecommunications sector (more so than in the energy and transport sectors). Policy-makers aim to achieve a degree of regulated competition in the market. Their two pivotal goals are to capture competition-related benefits in terms of efficiency and competitiveness, and to absorb advanced technologies from foreign companies. Yet, even after the phasing out of state monopolies, the Vietnamese telecommunications market, like those of most other countries, retained a strongly oligopolistic structure.[169] However, more open and sharpened competition eventually

[167] See Gabriele (2005).
[168] 'State-holding enterprise' (SOSHE) is the term used by official Chinese statistical sources to refer to those mixed enterprises where the state holds a property share sufficient to enable it to exert substantial and strategic managerial control over the firm. Other mixed enterprises do exist in China, where the state holds a minority share and therefore the control (at least, from a legal and formal viewpoint) is in the hands of private agents. It is a well-known fact, however, that the state and the Party usually do exert considerable influence on large private and non-SOSHE mixed enterprises through several channels, among them state-owned banks and enterprise Party organisations.
[169] See Gabriele (2005).

emerged in some sub-sectors (such as advanced wireless services), leading some officials and operators to denounce the risks of excessive competition.[170]

The role of the state, far from being minimised, was strengthened in a new and modern way, with a division of tasks between different public actors. SOEs play a direct entrepreneurial and managerial role as the largest firms and the main partners of TNCs in the domestic market. The Ministry of Planning, the line ministries and the other bodies and committees which directly supervise telecommunications and other infrastructural industries try to streamline, rationalise and make more effective their strategic planning role. In 2011, sectoral regulatory functions were transferred to a separate agency endowed with a high degree of autonomy.[171]

The results of telecom reforms in Vietnam have been impressive. The Vietnamese telecommunications sector is one of the fastest-developing in the world, second only to China in terms of growth, coverage expansion and technology renewal. In the specific area of widening access to mobile cellular phone communications, Vietnam appears so far to have been more successful than China.[172] By the end of 2011, Vietnam had reached 127.3 million mobile phone owners, 10.2 million landline subscribers and 30.5 million internet users. More than 16 million people used 3G mobile networks. IT use in state agencies has also contributed to administrative reforms.[173]

This summary of the structural telecom reforms carried out in Vietnam since the mid-1990s shows that they have followed a policy approach broadly similar to that of China. The overall results have also been quite similar in both countries. Similar patterns can be observed in most other sectors and areas of economic and social policy, not all of which have led to positive results.[174]

It is likely that all MSSEFs are bound to face similar crucial systemic challenges, once they reach a certain level of overall economic development. Actually, MSSEFs can be seen as a sub-

[170] See Telegeography (2012), 'Vietnamobile seeks help amid rising competition', 25 June.
[171] See ITU (2012), 'Regulating in a broadband world', *Trends in telecoms*, No. 4.
[172] See Graph 1 above.
[173] See ITU (2012).
[174] **Ill-fated marketisation/privatisation trends in the area of basic public services constituted by far the gravest policy blunders, both in China and Vietnam. They were the foremost drivers of the dramatic tendency towards widening social inequality, significantly slowing overall human development and leading to long-lasting, severe structural problems, the most egregious of these in the area of public health (see Bloom, G. and G. Xingyuan (1997), 'Health sector reform: Lessons from China',** ***Social Science & Medicine*** **45:3, pp. 351-360; Gabriele, A. and F. Schettino (2008), 'Child Mortality in China and Vietnam in a Comparative Perspective',** ***Economic Change and Restructuring*** **41:1; Gabriele, A. and F. Schettino (2009), 'Determinants of Child Health in Developing Countries: the Experience of China and Vietnam' in** ***Economics of Developing Countries*****, Nova Science Publishers, Inc., Hauppauge, NY.; Ramesh, M. (2013), 'Health Care Reform in Vietnam: Chasing Shadows',** ***Journal of Contemporary Asia*** **43:3, pp. 399-412).**

class of developing countries sharing some key systemic features that allow them to be identified as such.

This point can be seen as a special manifestation of the more general and widely held view that all countries have to go through a certain number of stages during their developing trajectory. Such a view should not, of course, be interpreted in a mechanic and absolute sense, and is not exempt from exceptions.

7. Concluding Remarks

China's approach to reforming strategic infrastructure services is based on the preservation and strengthening of a few SOEs and/or SCMEs, one of which usually retains a dominant position, in the framework of an oligopolistic market structure governed by sector-specific government policies and regulatory agencies.

The reformers pursued several objectives at the same time, had to face a number of important trade-offs, and were forced to attach (explicitly or implicitly) proper weights to each goal. The most important goals – apart from the overarching one of maintaining strategic policy control over key infrastructure sectors – were to enhance efficiency, accelerate technical progress, reduce external dependency, expand access to basic services to the poor and improve China's international competitiveness.

The analysis of the reforms carried out in the telecommunications sector, the fastest-changing and most technology-intensive of all infrastructural services, has shown that China is still some distance from the extremely ambitious goal of achieving full technological independence and a first-class indigenous innovation capability. However, sectoral policies have progressively become increasingly bold, sophisticated and comprehensive, and significant progress has been achieved. Similarly positive results have been obtained in other crucial infrastructure service sectors. Planners' approach to the reform of infrastructure services is consistent with the main distinctive feature of China: the peculiarity of being one of the two presently-existing MSSEFs (the only other one being Vietnam) in a mostly capitalist global economy.

Due to historical and geographical reasons, among others, these new socio-economic formations have come into existence at different moments in time, and could count from the very beginning on very uneven physical and human capital and natural resources endowments. Yet, in the early stages of the reform period, they essentially faced the same key systemic problems. Subsequently, the acceleration of technical change and shifting international competitiveness dynamics, propitiated by the latest phase of globalisation, necessarily implied that two countries that were transiting through very different development stages were forced to deal with similar – and largely exogenously-determined – challenges during (approximately) the same period of time. Due to its crucial implications for nationwide and cross-sectoral productivity and competitiveness, the reform of infrastructural services is one of the most important.

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Competitive Neutrality Issues in India

Seema Gaur

1. Introduction

This chapter[175] addresses the issue of competitive neutrality in India. Competitive neutrality presumes that there should be a 'level playing field' between state-owned enterprises (SOEs) and private firms in markets in which they compete with each other.[176] The concept of competitive neutrality implies that where public enterprises and private enterprises compete (or could potentially compete), both are subject to the same external environment (same set of rules), where this is in the public interest. This means that no business entity is advantaged (or disadvantaged) solely because of the nature of its ownership.[177] Competitive neutrality not only concerns potential disadvantages faced by private enterprises when they compete against SOEs, but also disadvantages faced by SOEs. Competitive neutrality is a minimum condition for setting up effective mixed markets, and ensuring that there are no artificial barriers to entry and that outcomes are efficient, given wider policy objectives.[178]

Competitive neutrality is a relatively new concept in most countries. The concept was first coined in Australia in the 1990s as part of reforms aimed at overhauling Australia's competition policy. However, the broader issues of public-private competition and the role of the state in the market place have been a subject of public debate in most jurisdictions, and are increasingly gaining the attention of policy-makers as a '21st century issue'. Formal endorsements of competitive neutrality are few, but many countries express a commitment to addressing aspects of competitive neutrality through commitments to a level playing field in the presence of government-owned businesses. Such commitments are implicitly expressed through competition law and a mosaic of other laws, regulations and policy guidance that apply to the activities of state-owned or -controlled businesses and the activities of government. Thus, aspects of competitive neutrality have been introduced through a network of laws, policies or regulations bearing on specific practices – including public procurement, competition policy and financial regulation – which contribute to levelling the playing field. A number of countries have levelled the playing field between public and private enterprises, to some extent, through the enforcement of competition law and by promoting better governance of their state-owned enterprises[179] along the lines

[175] The views expressed in this chapter are not necessarily official views of the Competition Commission of India.
[176] This is known as a 'mixed market', in which state and private entities co-exist or, given the rules and regulations actually in force, might co-exist.
[177] Capobianco, A. and H. Christiansen (2011), p. 3.
[178] OFT (2010), p. 5.
[179] OECD (2014), p. 4.

suggested by the 2005 *OECD Guidelines on Corporate Governance of SOEs.*[180] Competitive neutrality is a significant element of a country's competition policy and countries such as Australia, United Kingdom, United States and others have consistently advocated for the importance of this principle.

The main rationale for a level playing field between private and public players is that it enhances efficiency throughout the economy.[181] Where certain economic agents are put at an undue disadvantage, goods and services are no longer produced by those who can do so most effectively. Thus, competitive neutrality is important because it affects the efficiency of mixed markets as well as firms' incentives to innovate. It is therefore essential for the growth of markets and business, and to promote fair and healthy competition in the market economy. As a country reaches higher levels of development, it becomes increasingly important to level the playing field, which encourages the movement of capital from low- to high-productivity firms and sectors, thereby improving resource allocation.

A lack of competitive neutrality has short- and long-term effects.[182] The direct short-term effect is that contracts may not be awarded to the most efficient providers, and resources allocated inefficiently. Any inefficiency in the allocation of resources will harm consumers if it leads to higher prices and less choice than would be available in an efficient market. It is also likely that taxpayers would spend more on the provision of services than is needed. In the long run, there is likely to be a reduction in innovation and development of new, more efficient, production processes because any advances are offset by the competitive disadvantage faced as a result of ownership. The wider economy benefits from competitive markets because they encourage greater productivity and innovation and preserve long-term growth, while continuing to provide greater value for money to the taxpayer.

Thus, it can be said that some of the benefits of competitive neutrality[183] are: efficient allocation of resources resulting in efficient prices for consumers; long-term performance efficiency gains resulting from SOEs operating in a competitive environment; savings to government from better utilisation of infrastructure; transparency and greater efficiency in provision of public service obligations; and increased service quality as a result of better performance monitoring. Competitive neutrality also requires that governments should not use their legislative or fiscal powers to advantage their own businesses over the private sector. If governments do advantage their businesses in this way, it will distort the competitive process and reduce efficiency, more so if government businesses are technically less efficient than their private sector competitors.[184] While competitive neutrality is

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[180] OECD Guidelines on Corporate Governance of State-Owned Enterprises, Paris: http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211

[181] OECD (2012), p. 14.

[182] Office of Fair Trading report (2010), p. 14.

[183] OFT (2010).

[184] Capobianco and Christiansen (2011), p. 5.

desirable in general, there are instances where its strict application may hamper the achievement of important societal goals, such as in crisis situations or when dealing with market failures. However, even in such a situation it is necessary to ensure that a government-backed enterprise does not displace competition from private actors.[185]

In view of its relevance and benefits, the principle of competitive neutrality is widely accepted, yet achieving it in practice remains a challenge. SOEs, also known as public enterprises, are owned by governments rather than by private investors.[186] They compete directly with private profit-maximising enterprises in many important markets. Many SOEs perform both commercial and non-commercial functions. Thus imperfect distinctions and/or competing objectives may result in a number of challenges. On the one hand, SOEs may be expected to abide by market principles whilst continuing to fulfil public service obligations, which may put them at a disadvantage. On the other hand, there are concerns that SOEs receiving subsidies or guarantees may compete at an advantage and eventually become a 'dead weight' for the state.[187]

In India, competitive neutrality is highly relevant because India has adopted a mixed economy approach for economic development, which means the state sector and the private sector compete with each other. As in many developed and developing countries, SOEs in India have played a major role in industrialisation and economic development. The recent economic downturn has reaffirmed the confidence in SOEs in India as they have emerged relatively intact compared to private enterprises. SOEs in India emerged out of a mandate where the state was supposed to lay a strong industrial base in the economy and encourage self-reliant economic growth. However, following economic reforms in India in the 1990s, most of the markets that were previously dominated by state-owned monopolies have been opened to competition from private players. Consequently, markets where state-owned enterprises and private enterprises compete alongside one another have been growing. Therefore, competitive neutrality is vital to provide a level playing field for all players and to promote the efficient allocation of scarce resources and the growth and development of the economy. This chapter is divided into four sections. The first of these provides insight into the changing role of SOEs in the Indian economy over time, along with their rationale, nature, forms, contribution to the economy and their performance in terms of key parameters. The next section looks at some of the competitive neutrality issues in India and examines various measures taken by the government of India, as well as SOEs themselves, to improve their competitiveness alongside the private sector and provide a level playing field. Key measures currently being considered by government are also discussed. The following section discusses certain advantages and disadvantages that SOEs in India may still have. Some crucial issues

[185] OECD (2009), p. 12.

[186] A state-owned enterprise (SOE) can be either wholly or partially owned by a government and is typically earmarked to participate in commercial activities.

[187] OECD (2014), pp. 7-8.

that need to be addressed to make SOEs competitive and promote competitive neutrality in Indian markets are discussed in the last section. The chapter then concludes.

2. Rationale for SOEs in India

2.1 *SOEs after independence*

State-owned enterprises continue to have a major presence in many national economies and play a major role in the economic development of both developed and developing countries. State-owned enterprises have historically been important instruments for states to attain multiple goals. The genesis in different countries can be traced to ideological premises, social objectives and in many instances, the economic imperative of addressing market failure.[188] Examples include industrial policy, regional development, the supply of public goods and the existence of so called 'natural' monopolies.

In India, SOEs known as public sector enterprises (PSEs) or public sector undertakings (PSUs) play a pivotal role in the Indian economy. The underlying reason for the extensive presence of SOEs in the Indian economy lies in the economic policy adopted after independence. India, like many countries, adopted a mixed economy approach that encourages the role of the public sector as well as private sector enterprises. At independence, India was predominantly an agrarian economy, with a weak industrial base, low savings and insufficient investment in infrastructure. Hence, the Industrial Policy Resolution of 1956 gave primacy to the role of the state in assuming a predominant and direct responsibility for industrial development, and to help to achieve a 'socialistic pattern of society'.[189] The main objectives of setting up SOEs as stated in the 1956 Industrial Policy Resolution were: to drive rapid economic growth and industrialisation in the country and create requisite infrastructure for economic development; to earn returns on investment and, thus, generate resources for development; to promote the redistribution of income and wealth; to generate employment opportunities; to promote balanced regional development; to assist the development of small-scale and ancillary industries; to promote import substitution; and to save and earn foreign exchange for the economy. India's first Prime Minister Jawahar Lal Nehru's vision was that the public sector should capture the commanding heights[190] of the economy. The key factor that distinguished the creation and operation of these SOEs was the explicit emphasis on national interest over

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[188] CCI Chairperson Ashok Chawla's address at CCI Annual Day Workshop jointly hosted with UNCTAD on Competition Law and State Owned Enterprises, May 2012, New Delhi.

[189] The directive principles enshrined in part IV of the Indian Constitution aim to ensure that the state strives to achieve the welfare of the people by promoting the creation of a social order in which social, economic and political justice is provided to all citizens.

[190] 'Commanding Heights' refers to the critical sectors that dominate economic activity — primarily electricity generation, heavy manufacturing, mining and transportation. Government control of these particular sectors meant government dominance over the economic life of the nation. The term was coined first by Lenin in the 1920s.

market opportunity and profitability. Enterprises required large-scale investments that only the state could provide, whereas the private sector had neither the requisite resources at its disposal nor could be asked to make sacrifices of its commercial interest. A large number of SOEs were initially set up as green field projects. Others, mainly sick companies, were later taken over from the private sector. State-level SOEs were established because of the rising need for public utilities in the states (provinces).

According to Industrial Policy Resolution 1956, the emphasis on heavy industries would lead the economy towards greater long-term growth.[191] This Resolution identified three categories of industries:[192] those reserved for the public sector (state-owned sector), those permitted for the private sector with or without state participation, and those for which investment would come from private entrepreneurs. Industries of basic and strategic importance, or public utility services, were the responsibility of the public sector. Essential industries that demanded large-scale investment were also assigned to the public sector. Thus, the economy was planned to be mixed, with both public sector and private sector players, but the scope of the public sector was widened. Strategies specific to the public sector were later defined in policy statements in 1973, 1977 and 1980. The public sector was still central to the overall vision of a planned economy. At the same time, gradually, the role of the private sector was expanded. The 1973 Industrial Policy statement, *inter alia*, identified high-priority industries where investment from large industrial houses and foreign companies would be permitted. The 1980 Industrial Policy Statement focused attention on the need to promote competition in the domestic market, technological improvement and modernisation.

2.2 *A paradigm shift in the role of SOEs*

In 1991, liberalisation of the economy resulted in a paradigm shift in the Government of India's policy towards SOEs. The government initiated a systemic shift to a more open economy with greater reliance upon market forces. The 1991 Industrial Policy Statement[193] noted that 'many public enterprises have become a burden rather than being an asset to the Government.' The statement envisioned a greater role for the private sector, including foreign investment, and opened up sectors to competition. It also highlighted the need for SOEs to run on business lines and to innovate and lead in areas of 'strategic' importance. The 1991

[191] Industrial Policy Since 1956: http://www.drnarendrajadhav.info/drnjadhav_web_files/Published%20papers/Indian%20Industrial%20Policy%20Since%201956.pdf.

[192] The three categories were called Schedule A, B and C. Schedule A included 17 industries of basic and strategic importance; public utilities were also reserved for SOEs as large-scale capital investment was required to develop these industries. Schedule B included 12 industries given to the state without creating a monopoly; the private sector was also given the opportunity to develop enterprises in these industries. All other remaining industries were put in schedule C for the private sector subject to regulation under the Industrial Development and Regulation Act.

[193] Available at: http://dipp.nic.in/English/Policies/Industrial_policy_statement.pdf.

Industrial Policy Resolution defined certain priority areas for growth of SOEs such as essential infrastructure, exploration and exploitation of oil and mineral resources, technology development and building of manufacturing capabilities in areas crucial for long term economic development (where private sector investment is inadequate), and the manufacture of strategic products such as defence equipment. At the same time, the public sector was not barred from entering areas not specifically reserved for it. Whereas some reservation for the public sector was retained,[194] there would be no restriction for an area of exclusivity to be selectively opened up to the private sector. Industrial licensing was abolished except for a short list of industries related to security and strategic concerns, social reasons, hazardous chemicals and overriding environmental reasons, and items of elitist consumption. Over time, the number of reserved sectors was reduced drastically from 17 to eight and finally to just three: military equipment, atomic energy and railway transport. The private sector was gradually given access to all sectors of the economy except a few, and foreign direct investment (FDI) was now seen as a means to support domestic investment to achieve a higher level of economic development.

To raise resources and encourage public participation, the policy also called for the partial sale of shares of central SOEs and other SOEs to financial institutions and the public through the disinvestment program. Boards were to become more professional, and emphasis was placed on the Memorandum of Understanding (MoU) system to give managers greater autonomy, while holding them accountable. The policy called for the restructuring of poorly performing or sick enterprises while developing social security mechanisms to protect affected workers. Thus, the paradigm shift in public sector policy changed the scenario from a controlled economy to a market economy, full government ownership to disinvestment, unlimited life to threat of liquidation, employment generation to manpower rationalisation, liberal budget support to withdrawal of support, departmental Board to independent Board and limited autonomy to enhanced autonomy.

2.3 *The growth of mixed markets*

With the changed focus of the role of state-owned sectors in the economy since the 1991 reforms, SOEs began to vacate some of the commanding heights of the economy, where state responsibility for the provision of services was synonymous with state ownership. The command and control mode of governance that relied on state ownership gradually started moving towards a new mode of regulatory governance, where public private partnerships and private sector participation required governmental priorities to be achieved through economic regulation. State protection and budget support available to SOEs earlier has given way to the challenge of competition and domination of market forces. Due to most sectors hitherto closed to the private sector being opened up, SOEs are faced with stiff competition

[194] Areas where security and strategic concerns predominate.

from both domestic private sector companies (some of which have grown very fast) and large multinational corporations (MNCs). However, the growth of the private sector has not overshadowed the role of SOEs, as in India, they have continued their pivotal role in the economy and have expanded into many new areas. Consequently, there has been a rise in the number of mixed markets in India, i.e. markets where SOEs and private firms compete alongside one another. The issue is whether competition in these markets is affected by the existence of SOEs. This implies an increasing need to promote healthy competition between the private sector and SOEs by providing a level playing field, through promoting competitive neutrality.

2.4 *Types of SOE in India*

India is a union of states with a three-tier administration at central (federal), state (provincial) and local level governments. SOEs are found at all three levels in various forms. Central SOEs are primarily in sectors that fall either in the Central List or the Concurrent List of the Constitution of India, while state-level SOEs are in areas that fall in the State List of the Constitution. The central SOEs are small in number but represent a very large equity value. The state-level SOEs are about four times the number of the central SOEs, but in value terms they are lower. Most economic activity at the sub-national level is still carried out at state (provincial) level, and local-level SOEs are not very important and have not been considered in this report due to data limitations.

At any level of government, an SOE can take several specific forms. Major forms are depicted in the table below:

Table 1: Types of SOE in India

Type	Description	Examples
Government Companies	These are the main kind of SOEs in India today. They include companies incorporated under the Indian Companies Act 1956, where the central or state governments hold not less than 51 percent of the paid-up share capital.	Central: • Coal India Ltd, Delhi • Metro Rail Corporation • Steel Authority of India State: • Delhi Jal Board • Bihar State Electricity Board
Statutory Corporations	A statutory or public corporation is an SOE set up under a specific enactment by the central or state government.	• Food Corporation of India • Airports Authority of India • Damodar Valley Corporation • Central Warehouse Corporation • Inland waterways Authority of India
Departmental Enterprises	A departmental enterprise[195] is set up by the central or state government to provide essential economic services. They function under the control of the respective Ministries of Government of India (GoI)/State governments.	• India Railways • Indian Post • Ordinance Factory Board • All India Radio • Doordarshan (TV)
Public Sector Banks and Public Sector Financial Institutions	Public Sector banks, unlike public corporations, are subject to separate legislation: The Banking Companies (Acquisitions Act) and the Banking Companies Act of 1949. Public Sector financial institutions are engaged in providing long-term finance or financing institutions that lend to industries.	• Bank of Baroda • Agricultural Finance Corporation • Infrastructure Development Finance Company Limited
Cooperative Societies	Cooperative Societies are established pursuant to a specific policy objective, and hence considered as SOEs. The government uses the cooperative form of business organisation to execute some of its economic activities.	• Gujarat State Fertilizers Cooperative Limited • Indian Farmer Fertilizers Cooperative Limited • National Cooperative Housing Federation of India

[195] A departmental undertaking structure is considered suitable for activities that the government aims to keep in its control in view of the public interest.

Autonomous Bodies	Autonomous bodies[196] are societies set up under various Ministries to promote designated objectives. Administrative Ministries guide their activities.	• ESIC – Ministry of Labour • CSIR- Ministry of Science and Technology[197]
Trusts	They are usually SOEs that hold assets of the central or state government in the form of trusts.	• Port Trusts of India (having 199 major and minor ports)
Deemed Government Companies	These are SOEs covered under the Indian Companies Act and hold a major stake in the central Govt. equity but managed by the private sector.	• Allied International Products Limited • Chennai Ennore Port Road Company Limited

Source: Adopted from KPMG and CII (2013)

The next section reviews the evolution, contribution and performance of SOEs in India with a focus on Central SOEs.

2.5 *Evolution and growth of SOEs in India*

Prior to independence, there were only a few SOEs with a presence confined to railways, postal and telegraph services, and ordinance factories.[198] In pursuance of the Industrial Policy Resolutions of 1948 and 1956, the state made massive investments in basic and strategic industries such as steel, mining, metallurgy, coal, petroleum and chemicals, ship-building, shipping and heavy machine building.[199] The next phase involved the nationalisation of industries, the takeover of sick industries from the private sector, and the entry of the public sector into new fields such as manufacturing consumer goods, consultancy, contracting and transportation. In recent years, SOEs have penetrated into the production of essential

[196] Autonomous bodies are established whenever it is felt that certain functions need to be discharged outside the governmental structure with some amount of independence and flexibility without day-to-day interference from the government. These bodies are set up by the concerned Ministries or their departments and are funded through grants-in-aid, either fully or partially, depending on the extent which such institutes generate internal resources of their own. These grants are regulated by the Ministry of Finance (MoF) through their instructions. They are mostly registered as societies under the 'Societies Registration Act' and in certain cases they have been set up as statutory institutions under the provisions contained in various Acts.

[197] The Council of Scientific & Industrial Research (CSIR), the premier industrial R&D organisation in India, was constituted in 1942 by a resolution of the then Central Legislative Assembly. It is an autonomous body registered under the Registration of Societies Act of 1860.

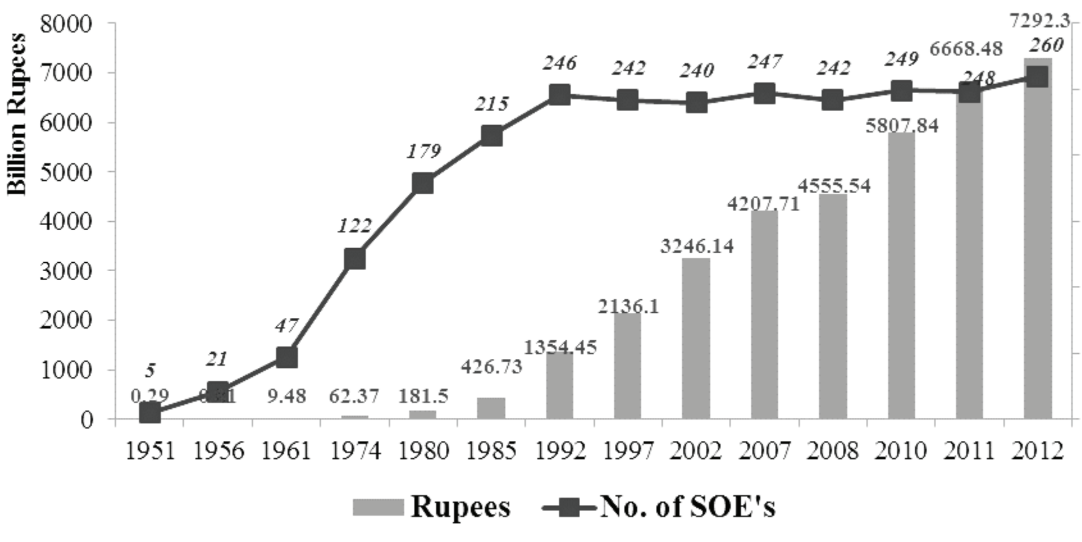
[198] Indian Telephone Industries Limited was the first SOE established in the country in 1948.

[199] Some of the largest and most successful SOEs, including BHEL, State Bank of India, ONGC, Indian Oil Corp, Oil India, Steel Authority of India and Bharat Electronics, owe their genesis to this period.

consumer goods and have begun to spread into wide areas of the economy, including non-infrastructure and other non-core areas. Thus, a vast empire of SOEs spread largely between central SOEs and state-level SOEs has been created. This chapter is largely focused on central SOEs (CSOEs).

There were 849[200] operating state-level SOEs in the country in March 2008. The state-level SOEs have played a very important role in providing infrastructure services such as power supply, road transportation, water supply and irrigation in the states (provinces). Some are also non-banking financial companies (NBFCs), set up to promote small and medium enterprises and agro-industries, while some are resource-based, (specific to the province) related to minerals, forest produce and tourism. Some state-level SOEs manufacture sugar, cement, engineering goods, soap and textiles.

As far as CSOEs are concerned, from only five CSOEs with a financial investment of Rs. 290 million,[201] they have grown to number 260 with a financial investment of Rs. 7,292.3 billion as of March 2012 (including 225 operating and excluding seven insurance companies). Over the years, CSOEs have expanded their presence in diverse sectors such as manufacturing, engineering, steel, heavy machinery, machine tools, mining, fertilisers, drugs, textiles, pharmaceuticals, petro-chemicals, extraction and refining of crude oil, telecom services, trade, warehouse and consulting.



Source: Public Enterprise Surveys, Department of Public enterprises[202]

[200] National Survey on State Level Public Enterprises 2007-08, p. 11, available at: http://dpeslpe.gov.in/DOC/SLPE_Vol-I.pdf.

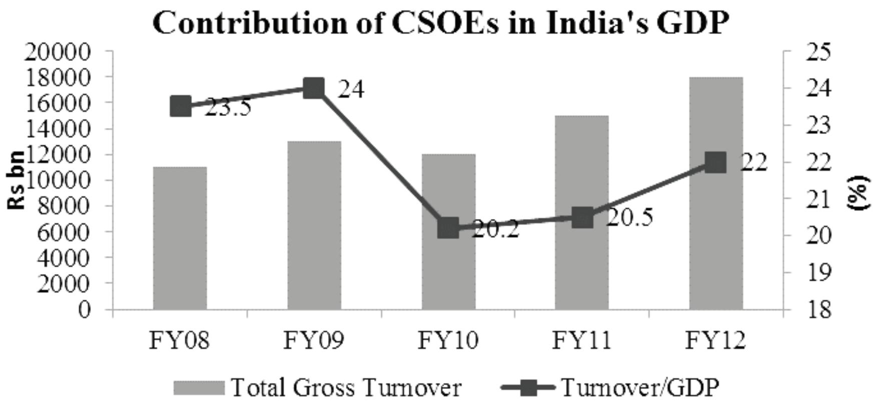
[201] Rs. refers to Rupees, the Indian currency. The current exchange rate is about Rs. 61 to 1 USD. The Indian Rupee was pegged to British Sterling from 1926 to 1966 at Rs. 13.33 to 1 Pound. The peg was changed to the US Dollar in 1966 at Rs 7.5 to 1 USD. Since then, based on the exchange rate regime, the rate has varied.

[202] The Department of Public Enterprises (DPE) presents to Parliament every year an overview of the financial, physical and socio-economic performance of Central Public Sector Enterprises (CPSEs, referred to as CSOEs in this chapter). The Public Enterprises Survey covers the Central Public Sector Enterprises (CPSEs) established by

2.6 *SOEs' contribution to the Indian economy*

Consequent to initiatives taken during the Five Year Plans, the role of SOEs in terms of contribution to the Indian economy has increased manifold. The SOEs have been instrumental in setting up a strong and diversified industrial base in the country,[203] and play multiple roles in the social and economic development of the country. On the one hand, they contribute significantly to India's GDP, even in an environment of severe economic crisis, and promote industrial and urban infrastructure. On the other hand, they provide large-scale employment and contribute significant portions of their profits towards social development and Corporate Social Responsibility (CSR) initiatives. Many SOEs also serve critical functions of furthering the socio-economic objectives of the government and ensuring stability in the prices of key products and commodities.[204] Their role and contribution to the Indian economy is briefly discussed below:

1. **CSOEs have a turnover equivalent to 20% of India's GDP**: The contribution of CSOEs in terms of total turnover as a percentage of GDP has ranged from 20-24% during the financial years 2008-2012.



Source: Public Enterprises Surveys, 2009-12, Department of Public Enterprises

2. **Domination of key sectors of the economy**: Despite the fall in market share after the opening up of most sectors to the private sector, SOEs continue to hold control across vital sectors. They have a complete monopoly in nuclear power generation. Other leading areas of dominance are coal (over 80%), crude oil and natural gas (over 70%), oil refining

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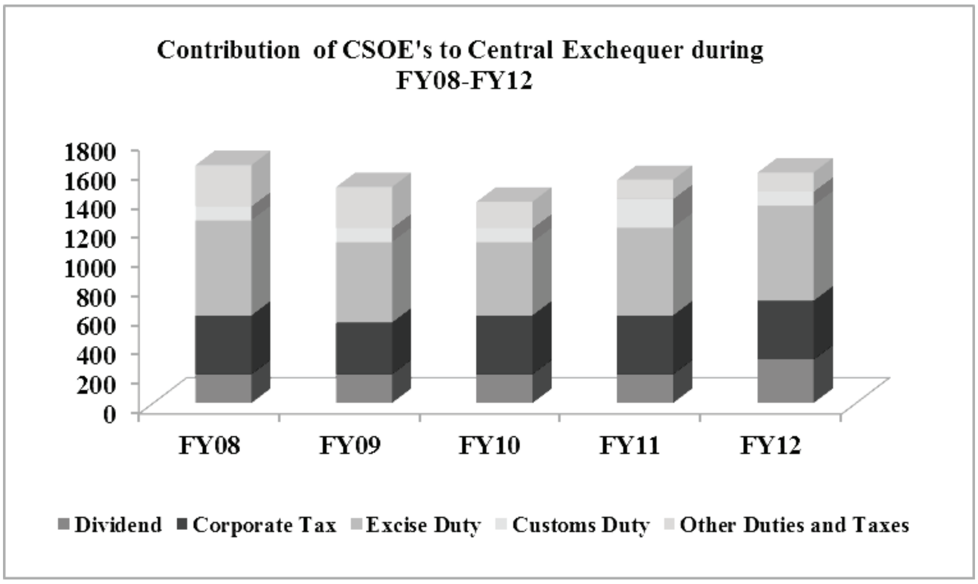
the Government of India as government companies under the Companies Act or as statutory corporations under specific statutes of Parliament. However, the survey does not include commercial banks and financial institutions. This survey covers only those government companies in which the central government's holding in paid up share capital is more than fifty per cent and also covers the subsidiaries of such CPSEs.

[203] This includes regions where industry did not exist earlier and into which it probably would not have gone for many more years but for state intervention.

[204] KPMG & CII (2013), p. 1.

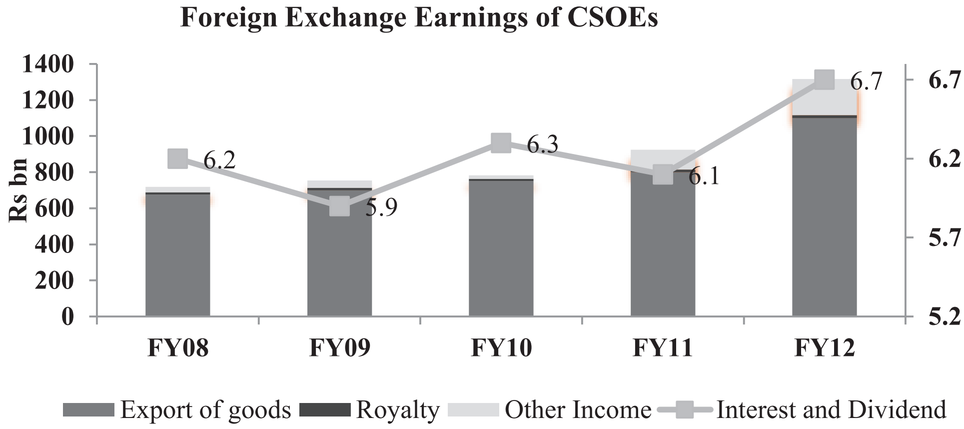
and marketing (over 55%), power generation and wired lines (over 80%). In comparison to 1998-99, however, their share in some of these industries has been significantly reduced over the years.

3. **Contribution to Central Exchequer**: The Central Exchequer sources the majority of its revenue from CSOEs through various taxes and duties as well as dividend payments and interest on government loans. On average, payments of excise duty and corporate taxes accounted for approximately 40% and 25% of the contribution to the Central Exchequer respectively during the financial years 2008-2012. While the contribution from excise duty, customs duty and interest has decreased during this period, the contribution from dividend payment on government investments and payment of corporate tax has increased.



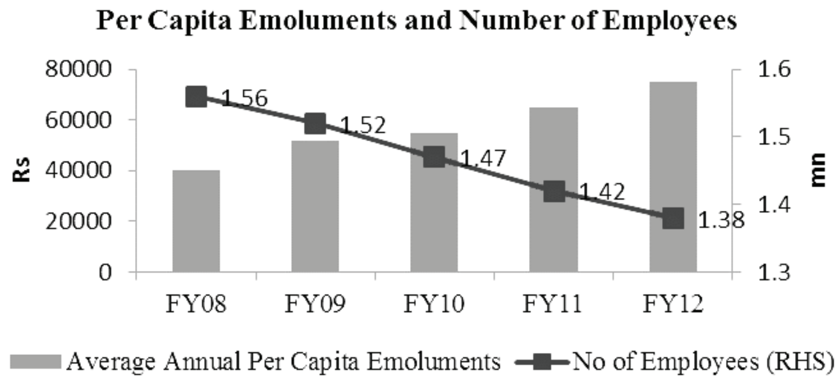
Source: Public Enterprises Surveys, 2008-12, Department of Public Enterprises

4. **Forex earnings**: CSOEs contribute significantly to the overall foreign exchange earnings of the country through exports of goods and services, royalty and consultancy services, and interest earnings. A total of 34 CSOEs' foreign earnings grew at a cumulative aggregate growth rate of 16.5% during the financial years 2008-2012 and constituted 9% of the country's total export earnings. The main source of foreign earning is the export of goods and merchandise, which accounts for about 88% of total earnings.



Source: Public Enterprises Surveys, 2008-12, Department of Public Enterprises

5. **Contribution towards employment generation in the organised sector**: CSOEs have made a significant contribution towards employment generation in the organised sector, although there has been a steady decline over the years due to increased automation across key industries in manufacturing and services.



Source: Public Enterprises Surveys, 2008-12, Department of Public Enterprises

6. **Role of SOEs in social and economic development of the country**: In addition to economic development, SOEs have been champions of inclusive growth for the economy by fulfilling their responsibilities towards the social development of the nation through employment generation, provision of basic infrastructure and public utilities, protecting consumers from commercial exploitation, promoting remote regions of the country and achieving balanced regional development. A large number of SOEs have been set up in remote areas of the country, thus leveraging the local talent available and providing employment avenues for populations in these regions. The establishment of SOEs paved the way for the development of infrastructure in these vicinities, by constructing or improving existing link roads and roads within villages, to make them increasingly accessible to SOEs.[205]

[205] KPMG & CII (2013), p. 8.

2.7 *Performance of CSOEs*

State-owned enterprises in India have responded admirably to economic reforms and liberalisation and successfully established their sustainability in the liberalised environment. Not only did they expand production and profits levels, they are also an important choice of investment for global and domestic investors today. These enterprises are growing in size and stature, competing with the major players in domestic and international markets, by focusing on business growth and diversification as well as profitability and productivity. They have also proved their resilience during the global financial crisis. Many CSOEs have successfully competed with the private sector and emerged as winners. Five CSOEs – ONGC, NTPC, Coal India, GAIL (India) and BHEL – alongside the State Bank of India, form part of the benchmark index, the S&P BSE Sensex. The stellar performance of prominent CSOEs is also borne out by the fact that out of the eight Indian companies selected in the Global Fortune 500 list for 2013, four were CSOEs[206] including one state-owned bank. However, even as CSOEs as a group have grown in size in the last two decades, individually, many are still suffering from major, and in certain cases, worsening problems. For many CSOEs, each new wave of competition has proved debilitating rather than energising. For instance, telecom major Bharat Sanchar Nigam Limited (BSNL)'s market share has fallen from a near-monopoly position to 11% in the last 20 years. Many SOEs have also not been able to fully benefit from India's economic liberalisation during the last two decades.

The performance of CSOEs along key dimensions is analysed below:

1. **CSOEs post the highest growth in turnover in past five years**: The turnover of CSOEs has grown at close to a 14% cumulative aggregate growth rate during the financial years 2008-2012, with performance varying from industry to industry. According to D&B India's top PSUs 2013,[207] the top line of Indian public sector companies grew by over 20% during 2011-12, which was their best aggregate performance in the last 10 years.

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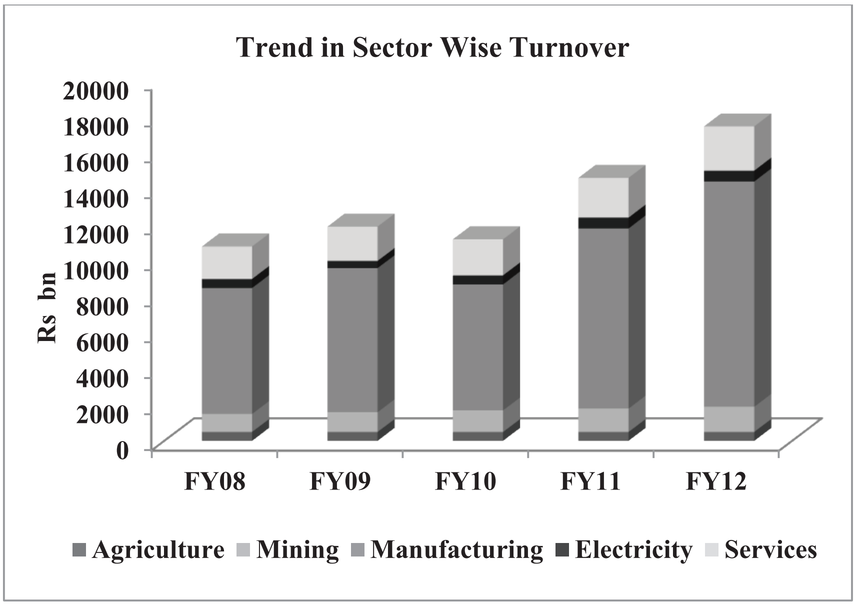
[206] Indian Oil, BPCL, SBI and ONGC.

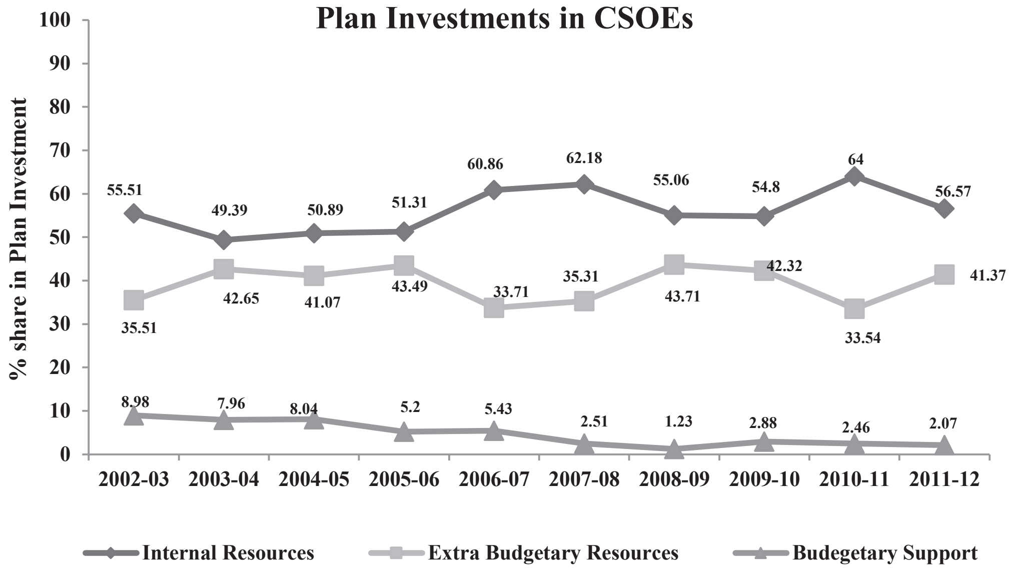
[207] Dun & Bradstreet (D&B), the world's leading provider of global business information, knowledge and insight launched the sixth edition of its premium publication, 'India's Top PSUs 2013' in May 2013.



Source: Public Enterprises Surveys, 2008-12, Department of Public Enterprises

2. **The Financial Performance of CSOEs**: In the post-reform era, CSOEs have shown a marked improvement in their financial performance:[208]
    - **Increase in Investments**: Financial investment in CSOEs grew at a cumulative average growth rate (CAGR) of 12 per cent from Rs. 4,555 billion in 2008 to Rs. 7,292 billion in 2012. The enhanced scale of operation, along with up-to-date technology adoption to counter stiff competition, has led to increased financial investments in CSOEs.
    - **Increase in self-reliance for investment financing**: The number of CSOEs dependent on budgetary support extended by the central government has gradually decreased over the years. Budgetary support as a percentage of the total investment outlays in CSOEs has declined from 9% in 2002-03[209] to 2% in 2011-12. On the other hand, the share of extra budgetary resources has increased from about 36% in 2002-03 to nearly 41% in 2011-12. This indicates that CSOEs have become more self-reliant and have been able to raise funds through internal accruals and loans from banks and financial institutions.

[208] Public Enterprise Survey 2011-12, Department of Public Enterprises.
[209] 23.5% in FY 1992.

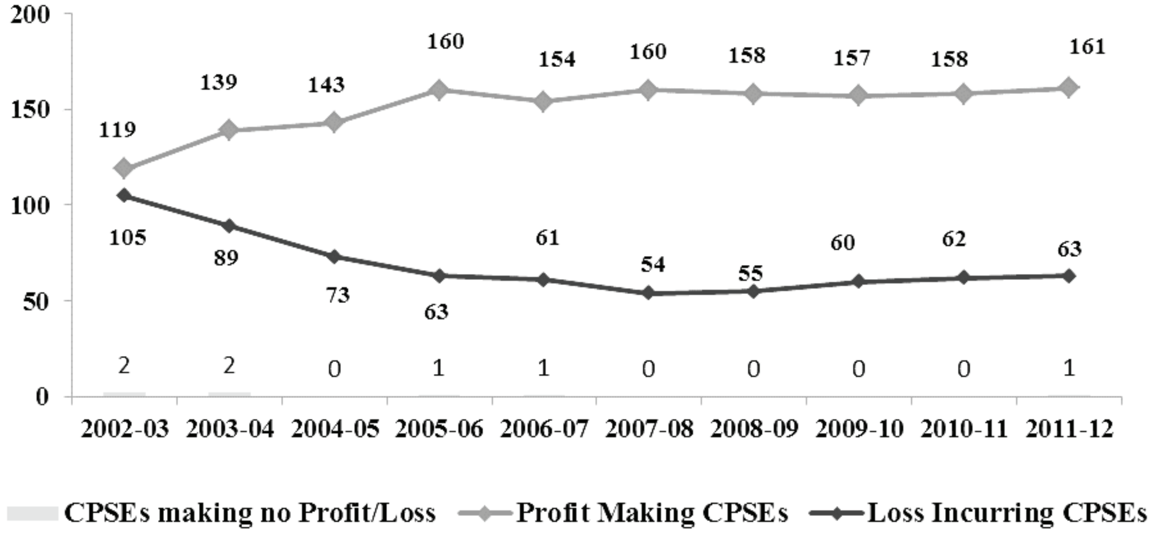


Public Sector Enterprise Surveys, 2002-2012, Department of Public Enterprises

3. **Trends in profitability**: There has been phenomenal rise in the number of CSOES that post profits. Of the 225 operating CSOEs, a majority, i.e. 161 (72%), were profitable in 2011-12, while 63 made losses.[210] It is noteworthy that while the number of profit-making SOEs has increased, from 119 in 2002-03 to 161 in 2011-12, the number of loss-makers has reduced from 105 to 63 over the same period. This is indicative of improving performance of SOEs and their ability to face competition after liberalisation. However, the losses have increased from Rs 109.72 billion to Rs. 276 billion during this period. The top three CSOEs, namely Bharat Sanchar Nigam Ltd. (BSNL), Air India Ltd. and Mahanagar Telephone Nigam Ltd. (MTNL), alone incurred losses equal to about three-quarters of the total loss of all CSOEs in 2011-12.[211]

[210] The number of loss-making CSOEs has increased from 54 in FY08 to 63 in FY12 with their losses increasing from 103.3 bn in FY08 to 276 bn in FY12.
[211] The top ten loss-making companies accounted for 90% of the total losses by the 63 CSOEs during 2011-12.

Performance of CSOEs, 2002-2012



Source: Public Enterprises Surveys, 2002-12, Department of Public Enterprises

4. **Reduction in number of sick SOEs**: The number of 'sick' CSOEs[212] has reduced from 90 in 2004-05 to 66 in 2011-12, out of which 44 CSOEs[213] were registered with the Board for Industrial and Financial Reconstruction (BIFR)[214] created under the establishment of the Sick Industrial Companies Act 1992.[215]

5. **Achievement of targets achieved under Memorandum of Understanding signed with the government**: The annual evaluation of CSOEs by MoU[216] reveals that CSOEs are faring better while trying to achieve their annual targets. During 2007-08 to 2011-12, around two-thirds of MoU-signing CSOEs have an 'Excellent' or 'Very Good' rating, indicating a healthy performance.[217]

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[212] In some cases, the cause of sickness is historical such as the takeover of private textile companies for socio-economic considerations, like protection of employment in the early 1970s, which could not be modernised. In others, companies became sick over the years due to inadequate job orders, high labour costs, lack of finance, technological obsolescence, high input costs and competition from cheap imports. Other common problems have been poor debt-equity structure, weak marketing strategies and slow decision-making processes.

[213] Although a total number of 63 CSOEs had been referred to BIFR by 2007, there are only 44 CSOEs that are in operation. Out of the remaining 19 CSOEs, 18 CSOEs are closed and one has ceased to be a CSOE.

[214] The Board for Industrial and Financial Reconstruction (BIFR) is part of the Department of Financial Services of the Ministry of Finance, Government of India. Its objective is to determine the sickness of industrial companies and to assist in reviving those that may be viable, while shutting down the others.

[215] The Sick Industrial Companies (Special Provision) Act, 1985 (SICA) brought CSOEs under its purview in 1991 (made effective from 1992). Under the provisions of SICA, the CSOEs (with at least five years of registration) whose accumulated losses are equal to or have exceeded their net worth may be referred to the Board for Industrial and Financial Reconstruction (BIFR).

[216] A higher MoU rating reflects greater autonomy for public sector enterprises vis-à-vis the control of the government.

[217] Department of Public Enterprises (2012), Public enterprises Survey. .

6. **Market capitalisation of SOEs**: Market capitalisation of CSOEs in India constitutes a major portion of the total market capitalisation and several CSOEs attract huge investor interest. Based on the growth witnessed in market capitalisation of the listed CSOEs, they have emerged as major wealth creators for investors and stakeholders.[218] On 31 March 2014, the 50 CSOEs listed on the stock exchanges (BSE and/or NSE) collectively contributed about 15% of the market capitalisation. Of the top 10 listed companies on BSE, five are SOEs.

Company	Market Capitalisation (Rs. Million)
Oil & Natural Gas Corp. Ltd.	2,72,663.47
Coal India Ltd.	1,81,848.13
NTPC Ltd.	98,904.35
Indian Oil Corp. Ltd.	67,739.87
NMDC Ltd.	55,287.96
Gail (India) Ltd.	48,635.26
Power Grid Corp. of India Ltd.	48,168.77
Bharat Heavy Electricals Ltd.	47,663.04
Oil India Ltd.	33,283.57
Steel Authority of India Ltd.	29,491.95

Source: http://www.divest.nic.in/

7. **Global footprints of Indian CSOEs**: Increasing globalisation and the integration of the Indian economy with global markets has not only created new challenges but also opened up new opportunities. The central government is encouraging profit-making CSOEs with competitive advantage and growth potential to expand globally by granting them autonomy. There is growing emphasis on securing high export earnings from these enterprises, and they have been allowed to mobilise funds from abroad through various channels. This has helped them to undertake global forays through establishing Indian subsidiaries abroad, joint ventures, and mergers and acquisitions (M&A).[219] In 2011-12, 21 CSOEs[220] raised funds from abroad in the form of secured and unsecured loans. An OECD study[221] found that out of Forbes' Global 2000 list of the world's largest 2000 public companies in 2010-11, 204 are majority SOEs. While China led the list with 70 SOEs, it was followed by India with 30 SOEs.

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[218] Deloitte (2010), p. 7.

[219] For instance, ONGC Videsh has acquired oil and gas assets abroad and has invested in 30 exploration and production projects in 14 countries, either directly or through wholly owned subsidiaries/JVs. RITES Ltd. has been able to secure consulting projects in 62 countries across Africa, South-East Asia, the Middle East and Latin America.

[220] Shares of Mahanagar Telephone Nigam Limited (MTNL) are listed in the New York Stock Exchange (American Depository Receipts). Gas Authority of India Limited (GAIL) and the Steel Authority of India (Global Depository Receipts) (SAIL) are listed on the London Stock Exchange (Global Depository Receipts).

[221] Kowalski et el (2013), p. 6.

3. Competitive Neutrality Issues in India

3.1 *Competitive neutrality issues*

Post liberalisation, the policy initiatives of various Ministries form a statement of intent to encourage the participation of both the public and the private sector in achieving planned growth. However, the absence of a level playing field continues to make it difficult for the private sector to be able to play a more effective role in development and growth plans. Major areas of concern relate to the availability of land, mineral linkages, statutory clearances, and purchase preference to SOEs in some sectors.[222] A CIRC & IICA study (2012)[223] notes that the violation of competitive neutrality principles has been mostly found in sectors where a prominent SOE exists, such as coal, airports, education, housing, airlines and railways. From the competition distortions identified in the sector studies,[224] it is clear that competitive neutrality has been violated for reasons such as preferential access to a natural resource (e.g. coal), exemption from application of a rule for a business operation (e.g. education), grant of an incentive (e.g. housing and railways), preferential financial assistance by the government (e.g. airlines), and preferential access to a facility (examples exist in all transport sectors).

There are several instances of policy-related distortion of competitive neutrality.[225] For example, the proviso to Section 104 of the Motor Vehicles Act states that temporary permits to private parties in respect of notified areas can be provided only if the State Transport undertaking has not applied to ply their vehicles on that particular route. This is *prima facie* anti-competitive as it discriminates against private parties and has been found to result in anti-competitive outcomes. The preferential treatment granted to national carrier Air India with respect to access to government funding through regulations and practices is another example. Similarly, there are other instances of distortion in other sectors such as banking. In 2011, the Reserve Bank of India (RBI) directions for a 1% subsidy on agricultural loans was made available to state-owned banks but was not offered to private ones, thus dampening their efforts to plan rural branches.

The principle that the playing field should be levelled between SOEs and private firms is also true in the reverse. It is not only about potential disadvantages faced by the private sector when it competes against SOEs – which is how it is commonly understood – but the reverse as well. Interestingly, there are cases where the private sector has been favoured against the public sector. For example, in the civil aviation sector, for many years, state-owned airlines (including Air India) have not been successful in procuring new aircrafts to expand their fleet. As a result, many unused bilateral traffic rights have been allocated to private airlines, which

[222] CIRC & IICA (2012b), Report on Competition Advocacy (Public Sector), p. 4.
[223] CIRC & IICA (2012a), pp. 6-7.
[224] Sector studies carried out by CIRC for the Indian Institute of Corporate Affairs.
[225] Largely based on CIRC & IICA (2012b).

have been allowed to operate lucrative domestic and international routes already serviced by Air India.[226] SOEs may also suffer from a lack of a level playing field due to many disadvantages faced from being part of the state, particularly 'over-governance issues' that seriously limit their operative freedom to compete against the private sector. This aspect is discussed in detail in section 4.2.

Sometimes, based on public interest, deviation from principles of competitive neutrality may be justified. A situation for such deviation can be seen in the health sector, where government-owned hospitals can import medical devices and equipment at a lower duty rate if the product is sourced directly from the manufacturer. This is not applicable to private institutions. This deviation from the principle of competitive neutrality may, however, be justified on the grounds that government hospitals provide free (or highly subsidised) services to poor people.

India's Prime Minister, Dr Manmohan Singh,[227] put the issue of competitive neutrality in proper perspective recently:

> Several possible distortions can arise because of the advantages some SOEs have due to their government ownership. Competitive neutrality requires that the government does not use its legislative and fiscal powers to give undue advantage to its own business over the private sector.

3.2 *Measures taken*

A World Bank report (2010)[228] notes that since liberalisation began in the early 1990s, the Government of India has taken a number of steps to bring market discipline to SOEs. Radical solutions attempted in many countries, such as outright privatisation of commercially viable units and closure of unviable units, were eschewed from the outset, in favour of a more cautious approach. CSOEs have been subjected to direct competition from the private sector through the opening up of sectors to new private entry. Direct budgetary support to firms has been significantly reduced. Indeed through the payment of taxes and dividends, CSOEs as a whole have become a major net contributor to the national budget. Procurement preferences that once favoured CSOEs, and that had been in place since 1971 and subsequently modified over the years, have been by and large removed. The competitiveness of CSOEs has been enhanced by improving managerial autonomy, and ensuring greater market accountability. This was combined with 'disinvestment' involving sale of a portion of the government equity

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[226] Pradeep S. Mehta (2011), 'Competitive Neutrality in Public Policy', *Business Standard*, 22 August.

[227] Inaugural Speech at BRICS International Competition Conference, New Delhi, 21 November 2013, available at: http://www.cci.gov.in/May2011/Home/Speech_PM_3rdBRICS_Nov212013.pdf.

[228] World Bank Report (2010), 'Corporate Governance of Central Public Sector Enterprises: Republic of India', p. 20.

in SOEs while retaining majority control with the government. GOI shareholding in the companies has been reduced through listing of companies on the stock markets. Legal distinctions between CSOEs and private sector companies have been gradually eroded. Taken together, these steps have led CSOEs to compete more fairly with the private sector, have helped bring greater market discipline to the companies and helped to address some competitive neutrality concerns. The regulatory framework, as well as some of its key measures, for SOEs to compete with the private sector and to create a level playing field is briefly discussed below:

1. **Common legal and regulatory framework**: CSOEs are generally subject to the same legal and regulatory framework as the private sector, although some laws may contain special provisions or exemptions for state-owned enterprises. The important institutions include:
    - **The Securities and Exchange Board of India (SEBI)**, which protects the interests of investors in securities and promotes the development of the securities market through appropriate regulation;
    - **The Ministry of Company Affairs (MCA)**, which oversees compliance with the Companies Act; and
    - **Sector regulators**, like the Telecom Regulatory Authority, which regulate pricing and other sector specific issues for relevant CSOEs. A 2014 OECD report[229] notes that 'sector regulation plays an important role in allowing a country to gradually work towards implementation of a level playing field sector-by-sector without undermining its interests in activities which are considered of national security or of strategic economic interest.' In many sectors liberalised after the 1991 reforms such as telecommunications, civil aviation, insurance, railway container traffic and gas distribution, the private sector is now competing with earlier government monopolies. In almost all of these sectors, the government holds a major share, and the problem of competitive neutrality is important. Therefore, after opening the sectors, the government made a paradigm shift in its policies and governance structure in some key infrastructure sectors, which are natural monopolies and network industries. The government set up regulatory bodies in many sectors to ensure greater competition and to create a level playing field among new and incumbent players. Beginning in the early 1990s, a number of independent regulators have been set up. These include the Securities Exchange Board of India (SEBI), Telecom Regulatory Authority of India (TRAI), Central and State Electricity Regulatory Commissions (CERC and SERCs respectively), the Insurance and Development Regulatory Authority of India (IRDA), the Pension Fund Regulatory and Development Authority (PFRDA), the Airport Economic Regulatory Authority (AERA), the Petroleum and Natural Gas Regulatory Board (PNGRB) and the Tariff Authority for Major Ports (TAMP). Recently, there have been proposals for a biotechnology regulator, a real estate regulator, a coal regulator,

[229] OECD (2014), p. 8.

and even a roads regulator. In the financial sector, a report by the Financial Sector Legislative Reforms Commission (FSLRC)[230] has recommended an overhaul of the financial sector regulatory architecture by merging some existing regulators and creating new ones. Thus, many new regulators have emerged in the last 20 years and many more are on the way. Some are doing well, while others are struggling to deliver. Outcomes have been mixed and in many cases, have fallen short of expectations.

2. **DPE guidelines**: In addition to the above, SOEs are also governed by Department of Public Enterprises (DPE) guidelines, which the private sector is not required to follow. DPE guidelines determine many practices and procedures of CSOEs, including those related to accountability, financial policies, human resource development, operation of CSOEs, functioning of boards of directors and the performance monitoring system. A large number of such guidelines have been issued over the years. In the mid to late 1990s, with a view to streamlining, GOI abolished many guidelines. About 200 guidelines[231] on various aspects of SOE operations still exist, some of which are binding, while others are voluntary.

3. **Divestment**: Following the 1991 Industrial Policy Statement,[232] divestment began in 1991-1992 with the divestment of Videsh Sanchar Nigam Limited (VSNL). Since then, divestment has undergone change both in approach and policy. During 1991-2001, 31 CSOEs were divested for Rs. 30 billion mostly by way of minority (up to a 20%) stake sales to selected financial institutions[233] in small lots. Between 2000 and 2004, a shift in the government policies allowed 'strategic sale' or divestment of government's stake in SOEs. In 2004, the largest divestment of Rs. 155 billion occurred involving the transfer of big blocks of shares and management control to strategic partners identified through competitive bidding. This removed the recurrent need for subsidising the divested loss-making enterprises.[234] Post 2005, divestment has been carried out through the sale of small equity stakes.[235] Now emphasis is on the sale of minority shareholding in unlisted, profitable central SOEs with 'net worth' in excess of Rs. 2 billion through Initial Public Offering (IPO).[236] Thus, divestment in India has been carried out overwhelmingly in the form of partial privatisation, without transfer of management control, as opposed to strategic sales leading to transfer of management control, with the exception of a few cases.

[230] Available at: http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf.
[231] http://dpe.nic.in/important_links/dpe_guidelines.
[232] The Industrial Policy Statement of 1991 stated that the Government would divest part of its holdings (minority share-holding) in select SOEs. The government's divestment policy was also identified as a tool to raise funds thereby reducing financing requirements of the SOEs.
[233] Life Insurance Corporation of India, General Insurance Corporation and Unit Trust of India.
[234] Such as Modern Food Industries and hotel properties of ITDC and Hotel Corporation of India.
[235] http://www.divest.nic.in/Dis_Current.asp.
[236] Under present disinvestment policy, the government is required to retain majority shareholding, i.e. at least 51% and management control of the public sector undertakings.

4. **Empowerment**: To help SOEs compete with private enterprises (who have the competitive advantage of taking business decisions on their own), the Department of Public Enterprises has taken key initiatives towards empowering SOE boards. The categorisation of profit-making CSOEs and awarding the 'Ratna' status was a significant step introduced in 1997 to grant increased levels of operational and financial autonomy to SOEs to equip them to react proactively to market forces. It also served as a mechanism to encourage more SOEs to review their strategies and perform better to achieve the coveted 'Ratna' status. After assessment based on select criteria, CSOEs are awarded the status of 'Maharatna', 'Navratna', 'Miniratna I' and 'Miniratna II', which determines the level of their autonomy. As of February 2013, out of 260 CSOEs, there are 7 Maharatna CSOEs, 14 Navratna CSOEs, 53 Miniratna I CSOEs and 16 Miniratna II CSOEs. The highest status, the Maharatna status, empowers the boards of companies to take investment decisions involving up to Rs. 50 Billion without seeking government approval. The eligibility criteria for classification into these categories are given in the table below:

Table 2: Classification criteria for 'Ratna' status

MINIRATNA-II	MINIRATNA-I	NAVRATNA	MAHARATNA
• Should have made profit for the last 3 years and have a positive net worth • Have not defaulted on loans/interest repayment to the government • No dependency on budgetary support or government guarantees • Boards restructured with the presence of at least three non-official directors • E.g. EdCIL (India), HMT (International) Limited, MECON Limited	• Should have reported profits in the last 3 years, with pre-tax profit of INR 300 million or more in any one of the last 3 years • Have not defaulted on loans/interest repayment to the Government • No dependency on budgetary support or government guarantees • Boards restructured with the presence of at least three non-official directors • E.g. AAI, BEML, BSNL, EIL, IRCTC	• Should be a Miniratna 1 and Schedule A company • Should have excellent/very good rating in 3 of the last 5 MOUs • Have secured composite score of 60 or more for 7 identical parameters/ratios • E.g. BEL, BHEL, BPCL, GAIL (India), MTNL, Oil India, SCIL	• Should have Navratna status • Listed on Indian stock exchange, with minimum prescribed public shareholding under SEBI regulations • Average annual turnover of over Rs. 250 billion in the last 3 years • Average annual net worth of over Rs. 150 billion in the last 3 years • Average annual net profit after tax of over Rs. 50 billion in the last 3 years • Notable global presence or international operations • E,g. Coal India, IOCL, NTPC, ONGC, SAIL

Special Status Central SOEs (as of February 2013)
Source: Department of Public Enterprises[237]

Boards of 'Ratna' Companies are empowered to independently take decisions in the areas of capital expenditure, joint ventures and subsidiaries, organisation restructuring, resource mobilisation and mergers and acquisitions, subject to defined limits that vary depending on the category of the CSOE. The powers of SOEs by category are listed in Appendix I.

[237] http://dpe.nic.in/publications/list_of_maharatna_navratna-and_miniratna.

5. **Accountability**: It is essential that greater autonomy and delegation are followed closely by accountability to shareholders. Therefore, along with the empowerment of CSOEs, the government has also focused on ensuring due accountability of SOEs in order to provide a level playing field with private sector entities. Two important tools have been used: Memoranda of Understanding (MOUs) and corporate governance.

    - **Memoranda of Understanding (MoUs)**: One of the earliest measures to produce accountability is the MoU system introduced in 1986.[238] An MoU is a negotiated document signed annually between the management of an SOE and the respective administrative department or Ministry. The SOE management agrees on performance targets to be achieved and the respective administrative department agrees on the support to be given during the year. At the end of the financial year, the achievements against targets are examined on both financial and non-financial parameters. The financial parameters are both in the form of absolute value, such as gross profit and turnover, as well as in the form of ratios. The non-financial parameters are classified as: i) dynamic parameters such as project implementation, quality of products and services and customer satisfaction; ii) sector-specific parameters related to macroeconomic factors such as change in demand and supply, price fluctuations and variation in interest rates; and iii) enterprise specific parameters related to issues such as safety and pollution. Specific weights are allotted to each parameter using a five-point scale varying from 'Poor' to 'Excellent' and a composite score is calculated, which is used to rate SOEs. These ratings also determine the categorisation of the enterprises[239] and consequently their level of empowerment.
      The MoU system aims to provide greater autonomy to SOEs vis-à-vis government control, while the management of the enterprises is made accountable to the government. The number of Central SOEs that signed such MoUs increased from 4 in 1986-87 (when the MOU system commenced) to 195 in the financial year 2013. A higher MoU rating gives greater autonomy to SOEs vis-à-vis government control. By laying stress on marketing efforts and comparing SOEs with private sector enterprises, the MoU system has proved conducive for SOEs to face competition. The MoU system has helped SOEs[240] to overcome some of their major problems in their day-to-day operation as well as to command a place of pride on the basis of performance. It has also addressed to some extent the problems caused by the multiplicity of agencies within the government, which kept setting different and often conflicting objectives, and the lack of clarity of objectives, which meant the management of SOEs could not

[238] The policy of using Memorandums of Understanding was recommended by the Arjun Sengupta Committee for measurement of performance of public enterprises.
[239] The Ratna status, i.e. Maharatna, Navratna and Miniratna I and Miniratna II.
[240] FM's speech at the seminar on 'PSU Disinvestments – Listing as a tool for improved corporate governance', 11 November 2011: http://www.divest.nic.in/PressRelease-seminar_on_psu_disinv_fm.asp

be held accountable for their performance. It also addresses the absence of functional autonomy, which handicapped PSEs in their operations.

- **Corporate Governance:** Corporate governance[241] has been an important part of the Government of India's broader CSOE and economic reforms, aimed at improving the performance and competitiveness of SOEs, making them more transparent and accountable, and allowing them easier access to capital markets. The reason why SOEs should be subjected to appropriate rules of corporate governance is two-fold. First, proper rules of corporate governance and transparency can limit any undue advantages that an SOE may enjoy due to state ownership to the minimum necessary for the accomplishment of its tasks. Second, the state, like any other shareholder, is interested in the SOE operating efficiently and effectively as it carries out its activities.[242] As noted by the Office of Fair Trading (OFT),[243] corporate governance is an important means of encouraging competitive neutrality as it ensures that SOEs operate in a way that does not unnecessarily distort the market. The OECD guidelines on the corporate governance of SOEs[244] also aim to facilitate the creation of a level playing field among private and publically owned incorporated enterprises operating commercially. The business activities of unincorporated segments of the government sector would become much more competitive and accountable if they were made subject to the guidelines. The underlying goal is to reorient the state's role away from a market player to a market regulator, and away from day-to-day management of CSOEs towards exercising its core ownership rights based on sound corporate governance principles.[245] Proper implementation of corporate governance helps countries manage their responsibilities as company owners more effectively, make SOEs more competitive, efficient, professional and transparent, besides allowing the creation of a level playing field for all market players. Various instruments used for improving corporate governance are briefly discussed below:
    a. **Companies Act (CA) 1956**: The Companies Act of 1956 has been the primary basis of governance of all public companies in India and thus applied to SOEs as well. CSOEs and other companies in which the government, directly or indirectly, holds 51 per cent or more of the paid-up share capital are incorporated under section 617 of the CA as 'government companies'. Most of the processes were more or less the same for all companies[246] except for auditors, who were appointed by the

[241] Given that the governance reforms in India were carried out in response not just to domestic developments but in the context of global developments as well, they closely follow Anglo-American developments like the Sarbanes-Oxley Act.
[242] OECD (2009), p. 13.
[243] OFT (2010), p. 30.
[244] OECD (2005).
[245] World Bank (2010).
[246] The CA contained some special modifications for government companies that make them distinct from other companies (for example, more flexibility in relation to the time and venue of the AGM and on certain accounting provisions), or exemptions from certain sections of the Act (e.g. declaration of benami share holdings,

Comptroller General of India (CAG) for SOEs and for mergers and amalgamations of CSOEs, where the same procedures were followed but the power of the High Court was exercised by the government.

b. **Companies Act 2013:** In August, 2013, India adopted sweeping reforms to its corporate governance norms and practices by passing the Companies Act 2013 ('Companies Act') to replace the Companies Act 1956. The Companies Act 2013,[247] ('New Act') operational from April 1, 2014 emphasises increased transparency, effective disclosures, self-regulatory mechanisms and greater board accountability. The New Act is an important step in bringing Indian company law closer to global standards. It is equally applicable to SOEs registered under the Companies Act. Its key features are:
   - The new legislation for the first time requires an independent director. Publicly listed companies are required to have at least one-third of the board as independent directors. These directors cannot serve more than two five-year terms. In addition, nominated directors will not be regarded as independent. The role of independent director, in part, is to act as a watchdog on both the promoters and the management of the company, and to protect minority shareholders' interests.
   - The New Act codifies the duties of directors, particularly the duty to act in good faith, to avoid any direct or indirect conflict of interest with the company, and to exercise due diligence and reasonable care in decision-making.
   - The New Act mandates the setting up of a National Financial Reporting Authority, which will monitor compliance with accounting and auditing standards. The New Act also increases requirements for internal controls.

   The New Act is likely to have far reaching implications for corporate governance in India.[248] Being equally applicable to SOEs and private sector players, it is expected to contribute to a level playing field between the two.

c. **Security Regulations/Stock Exchange Board of India (SEBI)'s Clause 49**: Listed CSOEs[249] fall under securities regulation and the listing agreement issued by the Securities and Exchange Board of India (SEBI). This includes basic disclosure requirements and Clause 49, which contains important corporate governance norms. Introduced in 2000 and revised in 2003-04, Clause 49 has both mandatory

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requirement for board sanction of contracts entered into with other government companies). The Act has now been replaced by the New Companies Act passed in 2013.

[247] On 30 August 2013, India enacted the Companies Act 2013 (the 'New Act'), which replaced the more than 50-year old Companies Act 1956. Not all the provisions of the New Act will come into force immediately as a number of them require the Government of India to draft rules and regulations for their implementation. These rules will be drafted in the coming months in consultation with stakeholders.

[248] The rules pertaining to corporate governance were released on 27 March 2014. The requirements of the Companies Act 2013 are now applicable for every company or a class of companies (both listed and unlisted).

[249] Except for very small companies (that is, those with paid up capital of less than Rs. 30 million and a net worth of less that Rs. 25 million throughout their history).

and voluntary provisions. Mandatory provisions[250] relate to board composition, CEO/CFO certification of financial statements, strengthening the responsibilities of audit committees, a widened definition of the term 'independent director', periodical review by an independent director, board procedures, internal controls and corporate governance reporting. Firms that do not comply with it can be de-listed and financial penalties may be imposed. The Clause[251] is equally applicable to SOEs and their private counterparts. In fact, many SOEs now face delays in their listing due to non-compliance with this clause especially relating to the number of independent directors on their boards. Therefore, the compulsion to list in order to raise resources from the market compels SOEs to have independent directors and comply with Clause 49, which improves their corporate governance. Clause 49 was revised in April 2014 in order to align it with the provisions of the Companies Act 2013 and to make the corporate governance framework more effective.[252]

d. **Corporate governance guidelines**: India is one of the few developing countries to have issued a corporate governance code for its CSOEs and in doing so has taken a big step forward in promoting the governance agenda.[253] While listed SOEs are required to comply with Clause 49 of the SEBI Listing Agreement, from 2010 it is mandatory that all central SOEs (including unlisted SOEs) comply with the Corporate Governance Guidelines,[254] which used to be voluntary. These guidelines are similar to the requirements of Clause 49. Most established codes of corporate governance for SOEs, including the OECD Guidelines on Corporate Governance of SOEs,[255] envisage the organisation playing a proactive role in: i) ensuring equitable treatment of shareholders; ii) recognising, respecting and reporting on relations with all key stakeholders; iii) maintaining high standards of transparency and disclosure; and iv) having requisite systems and practices for its board of directors to effectively discharge the role of guiding and monitoring the SOE. The Corporate Governance Guidelines for SOEs in India also aim to ensure management accountability to boards and shareholders, to protect shareholders' rights, to ensure timely and accurate disclosure on all material matters, to recognise the legal rights of stakeholders and to promote sustainable

[250] There are striking similarities between Clause 49 and the Cadbury report, OECD Principles of Corporate Governance and Sarbenese Oxley Act.
[251] Through the circular dated 8 April 2008, the Securities and Exchange Board of India amended Clause 49 of the Listing Agreement to extend the 50% independent directors rule to all Boards of Directors, where the Non-Executive Chairman is a promoter of the Company or related to the promoters of the company.
[252] Circular dated April 17, 2014 available at: http://www.sebi.gov.in/cms/sebi_data/attachdocs/1397734478112.pdf. The revised Clause 49 will be applicable to all listed companies with effect from 1 October 01 2014.
[253] World Bank (2010).
[254] See: http://www.dpemou.nic.in/MOUFiles/CorporateGovernance.pdf. The CG Guidelines were issued in June 2007 as voluntary guidelines, modelled largely along the lines of Clause 49.
[255] OECD (2005).

development. Most CSOEs in India would compare favourably when it comes to adoption of the above measures.[256] For example, the Oil and Natural Gas Corporation (ONGC) has been following the Corporate Governance Guidelines since compliance was still voluntary.

After some initial hiccups in implementing the various corporate governance requirements, listed CSOEs are now gradually improving compliance with corporate governance norms. DPE guidelines and Clause 49 have led to steady improvements in board composition and structure over time. Board composition, on paper at least, is comparable to many countries. The number of agenda items for board meetings has been on the decline, leading to more serious consideration of important issues. Independent directors are beginning to express their views and often call for more information and discussion of agenda items. All this augurs well for improved board performance. The combined influence of the new Companies Act with the Clause 49 of the Listing Agreement is expected to push India to the forefront of corporate governance in emerging global markets.

6. **Right to Information (RTI) Act 2005**: The RTI Act, which came into effect in 2005, is a landmark initiative for enhancing transparency and governance of the public sector as a whole. The RTI Act requires that various CSOE reports and statements be made available to the public. In practice, many CSOEs have established websites linked to those of their administrative ministry to meet the law's requirements. Documents that are not regularly disclosed to the public may also be demanded from CSOEs. The RTI Act has brought transparency and enhanced the image of CSOEs not only in the eyes of investors, stakeholders, government and civil society at large, but also in the international corporate sector. Therefore, CSOEs have come forward and adopted RTI in the best of spirits, even though there are some practical difficulties.

7. **Human resource development**: Attracting and retaining talent in CSOEs has become a major challenge. It is increasingly recognised that the deployment of quality human resources is critical for sustainable performance. Accordingly, in order to attract and retain quality talent, many SOEs are taking initiatives such as:
   - Adopting contractual recruitment in key management positions with market linked compensation including variable pay;
   - Organising training programmes aimed at capacity-building and augmentation of employees' skill sets;
   - Having a succession planning policy aimed at identifying employees with leadership potential and grooming them to fit the envisaged leadership roles.

[256] Deloitte & ASSOCHAM (2010), p. 13.

- Introducing a suitable pay structure for CSOE manpower to progressively align with counterparts in the private sector.

8. **Streamlining business processes and practices**: In order to ensure competitiveness with private sector players, SOEs are benchmarking their capabilities in terms of productivity, technology adoption, cost effectiveness, and service delivery against their private counterparts. The various initiatives being undertaken by CSOEs to reform their business operations include:[257]
   - Investing in state of the art technology with the objective of: i) improving product quality; ii) enhancing productivity through streamlining manufacturing processes; and iii) achieving cost reduction;
   - Deploying Enterprise Resource Planning (ERP) and Management Information Systems (MIS) to support business process re-engineering, which hastens decision-making processes, enabling CSOEs to react proactively to the market;
   - Benchmarking of practices with industry standards, which helps achieve greater efficiency and lower costs;
   - Increased outsourcing, particularly non-core activities and support functions, which enables CSOEs to focus on their core operations and enhance their productivity along with reducing overhead costs of the enterprises;
   - Increased focus on entering Public-Private Partnerships (PPP) primarily with the objective of attracting funds in sectors like infrastructure which require significant investments, along with requisite expertise of the private player.

9. **Competitively neutral public procurement - withdrawal of preference policy for SOEs**: In India, public procurement includes procurement made for and on behalf of SOEs. The courts in India have held that the principles enunciated in Article 14 of the Constitution (equality before the law) are applicable to public procurement and thus endorse competitive neutrality in public procurement. Competitive neutrality during the public procurement process is also important to ensure that the best competitive outcome is achieved. Procurement management can have a substantial impact on competition in the market.[258] From 1992, the procurement policy of the government mandated both central government departments and CSOEs to apply price and purchase preference in favour of the public sector. Under the policy, where the quoted price was within 10% of the lowest price of a large private sector, other things being equal, purchase preference could be granted to the SOEs concerned at the lowest valid price bid. This policy was initially intended to operate for only three years to give SOEs time to adjust to the new economic environment post the 1991 reforms. However, it was repeatedly extended until 2008 when, in order to provide private players with a level playing field and enhance

[257] Deloitte (2010) and KPMG & ASSOCHAM (2011).
[258] OFT (2010), p. 30.

competition, the general purchase preference policy (PPP) for the products and services of SOEs was withdrawn.

The move is expected to level the playing field for private sector companies in relation to government contracts in areas such as power, telecommunications, IT, defence, manufacturing and engineering. Another tool used to promote competition and achieve transparency in public procurement is e-procurement. To facilitate the implementation of e-procurement, the Government of India has established a Central Procurement Portal (CPP) with an e-publishing and e-procurement module. Tender enquiries, corrigenda and details of bid awards must be published on the CPP Portal using the e-publishing module in respect to all procurement, irrespective of size. In a bid to introduce greater transparency, all ministries and departments of the central government, and their attached and subordinated offices were required to commence e-procurement in respect to all procurements with an estimated value of Rs. 1 million or above, from 1 April 1 2012 in a phased manner.[259] To ensure maximum participation in tendering, it has been further decided to bring down these tender limits to Rs. 0.5 million from 1 April 2015 and to Rs. 0.2 million from 1 April 2016.[260]

10. **Competitively neutral Competition Act:** Competition law in India applies equally to the business activities of public and private sector enterprises. There is no differentiation or classification of the business activities of public and private sector enterprises in relation to the applicability of Competition Act 2002. This is discussed in detail in the next section.

3.3 *Competition Act 2002 and competitive neutrality*

There is a general consensus that competition law can help address competitive neutrality problems to some extent by applying equally to all enterprises irrespective of ownership. It can stimulate a competitively neutral environment, but can only deal with specific problems after they have occurred. Most competition laws define their scope as covering the conduct of any ‘person’ or ‘undertaking’, which are terms that have been generally interpreted as encompassing any entity engaged in a commercial activity regardless of the character of its ownership or financing. SOEs in India were exempt under the earlier competition law known as the Monopolies and Restrictive Trade Practices Act 1969, until economic reforms were launched in 1991. The message was loud and clear: the law would not be preferential to SOEs henceforth.

[259] Office Memorandum (OM) no. 10/3/2012-PPC dated 30 March 2012, issued by the Department of Expenditure, available at: http://eprocure.gov.in/cppp/sites/default/files/eproc/GuidelinesOn_e-Procurement.pdf
[260] Vide Circular dated 9 January 2014 issued by the Department of Expenditure, available at: http://eprocure.gov.in/cppp/sites/default/files/gos/e_Procurement.pdf.

Equality of SOEs and private enterprises is enshrined in Article 14 of the Constitution of India. The Competition Act 2002 further strengthens this mandate. The Indian Competition Act 2002 defines the term ‘enterprise’ in section 2 (h) as:

> a person or a department of the Government, who or which is, or has been, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or the provision of services, of any kind, or in investment, or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, either directly or through one or more of its units or divisions or subsidiaries … but does not include any activity of the Government relatable to the sovereign functions of the Government including all activities carried on by the departments of the Central Government dealing with atomic energy, currency, defence and space.

The above definition makes it clear that all the commercial activities of the government including SOEs come under the purview of the Competition Act 2002. However, government activities related to its sovereign functions, which include activity relating to energy, currency, defence and space, are not covered under the law. The statute is very clear that there should not be any discrimination between private and government players in relation to commercial activities and that all players should be treated equally, so as to provide a level playing field for all. This shows that competitive neutrality is enshrined in the Act.

Moreover, the preamble of the Act states that it is an ‘An Act to provide, keeping in view the economic development of the country, for the establishment of a Commission … to ensure freedom of trade carried on by other participants in markets, in India’. As a lack of competitive neutrality may affect freedom of trade carried on by other participants, the preamble also indirectly provides support to the notion of competitive neutrality.

Application of competitive neutrality limited by socio-economic objectives

Government entities sometimes operate with a non-commercial, non-profit purpose in order to maintain public service obligations such as maintaining postal, transport and telecommunication services in outlying areas, or providing essential utilities at affordable rates. Generally, the main reasons for government interventions in any jurisdiction are to correct market failures, to achieve a more equitable distribution of income and wealth and to improve the performance of the economy. Keeping these purposes in mind, the preamble of the Act aims to promote competition in the market. Section 19(3) (d) and (f) establish that while determining anti-competitive agreements, the Commission will have due regard to factors that include promotion of economic development by means of production and distribution of goods and services. Further, section 19(4)(k) provides that while determining the dominant position, the Commission has to see if the alleged conduct serves any social obligation or social costs in the society. Thus, the Act mandates the Commission to keep socio-economic obligations of the state in view, while applying the Act in a competitive neutral manner.

The role of the Competition Commission of India (CCI) in upholding competitive neutrality

The competition authorities can help create a level playing field for SOEs and private enterprises through i) application of competition law to both SOEs and private enterprises in a competitively neutral manner; and ii) acting as advocate for competitive neutrality policies with the government. The CCI is also performing both these roles:

1. **Enforcement**: During five years of enforcement, there have been various occasions where the Commission had the opportunity to intervene into the conduct of government enterprises. The Commission played a proactive role and looked into such conduct effectively. Some of the important orders of the Commission in this regard are briefly discussed below:
   - **Jindal Steel & Power Ltd. and Steel Authority of India Ltd. and Anr**:[261] CCI held that both Indian Railways (IR) and Steel Authority of India (SAIL) are enterprises. This order is significant as it highlights the approach taken by the Commission while deciding a case involving a government department or SOE. Jindal Steel and Power Ltd. filed a complaint with the CCI alleging abuse of a dominant position by SAIL, which had entered into an exclusive supply arrangement for rails with Indian Railways (IR) through an MoU. Therefore, other rail suppliers did not get the opportunity to put forward their bids as no tenders were issued by Indian Railways. With respect to the issue of whether the IR and SAIL fell within the definition of 'enterprise' under the Act, the Commission decided that SAIL is an SOE, in which the Government of India holds a 85% stake. Since it is engaged in the production and supply of a wide range of steel products including rails, it would undoubtedly fall within the scope of an enterprise under the Act. With regards to the status of IR, the Commission drew a distinction between the Ministry of Railways (MOR) and IR. It found IR to be a departmental undertaking of the Government of India controlled through the MOR. While IR performs the economic role of an enterprise, the MOR is vested with the role discharging the sovereign function aspect related to the railways industry in India. Since IR is a departmental undertaking of the MOR, and is engaged in the activity of public carriage of goods and other activities, it falls under the definition of 'service' under the Act and thereby fall under the scope of enterprise as set out in Section 2(h) of the Competition Act 2002.

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[261] Case No. 11/2009, available at:
http://www.cci.gov.in/May2011/OrderOfCommission/JINDALSTEELSUPP20dec2011.pdf.

- **PDA Trade Fairs and India Trade Promotion Organisation (ITPO)**:[262] PDA Trade Fairs, a business organisation engaged in organising international trade fairs filed information against ITPO alleging contravention of section 4 of the Act by ITPO. ITPO is a nodal agency of the Government of India engaged in organising fairs and exhibitions in India and has management and control over trade fair bookings at the major trade fair venue Pragati Maidan. CCI concluded that Pragati Maidan holds a unique position in Delhi because of its close proximity with all the modes of transport, national and international, its capacity, and huge footfall, which it attracts during exhibitions making it non-substitutable and a unique place for exhibitions. Thus *prima facie*, ITPO was in a dominant position in the market of providing venues for trade fairs and exhibitions within the geographic area of Delhi. However, CCI did not find any *prima facie* case of abuse of dominance against ITPO and closed the matter.
- **M/s Mineral Enterprises Limited and Ministry of Railways**:[263] Information was filed by M/s Mineral Enterprises Limited, a company involved in mining, trading and exports of iron ore, against the Ministry of Railways. The Railways Act 1989 empowered the central government to fix rates for the carriage of goods by the railways and to classify or reclassify any commodity for the purpose of determining the rates for its carriage. The Railway Board (under the Ministry of Railways) reclassified iron ore based on its end use, thereby imposing different freight charges on iron ore. Aggrieved by this classification, the informant approached CCI alleging abuse of dominant position by the Ministry. The Commission held that this was done in pursuance of authority given by the legislature to the central government to classify and revise rates and freight charges with respect to carriage of goods. Therefore, the Railway Board was exercising its statutory functions and the matter was closed.
- **M/s Maharashtra State Power Generation Company Ltd. and M/s Gujarat State Electricity Corporation Ltd and Coal India Ltd.**:[264] On 9 December 2013, the Competition Commission of India passed a landmark order by levying a fine of Rs. 17.73 billion (approx. US $290 million[265]) on Coal India Ltd., a state-owned enterprise, for abuse of dominance in the fuel-supply services market. Although CCI has imposed heavy fines on other firms, this was its first major penalty on an SOE. CCI passed the order on the basis of information filed by M/s Maharashtra State Power Generation Company Ltd. and M/s Gujarat State Electricity Corporation Ltd. CCI found that CIL operates independently of market forces through its subsidiaries and enjoys undisputed dominance in the market of production and supply of non-coking coal in India. It was also found that it is imposing unfair/discriminatory conditions and indulging in unfair/discriminatory conduct in the matter of supply of non-coking coal

[262] Case No. 48 of 2012, available at: http://www.cci.gov.in/May2011/OrderOfCommission/482012.pdf.
[263] Case No. 47 of 2012, available at: http://www.cci.gov.in/May2011/OrderOfCommission/472012.pdf.
[264] Case Nos. 03, 11 and 59 of 2012, available at:
http://www.cci.gov.in/May2011/OrderOfCommission/27/592012.pdf.
[265] At the current exchange rate $1 = 61 Indian Rupees.

to power producers. Further, CCI held that various clauses of the fuel supply agreements signed with the informants were in contravention of the provisions of section 4(2)(a)(i) of the Act and directed CIL to modify these agreements. When carrying out these modifications, CCI directed CIL to consult all the stakeholders and ensure parity between old and new power producers, as well as between private and PSU power producers, as far as practicable.

2. **Advocacy**: Competition law enforcement can contribute to creating a competitively neutral environment through its application to the conduct of enterprises ex-post, except in case of mergers, where it is applied ex-ante. However, competition distortions in markets can also arise due to a government law or policy, which may need to be corrected by legislation or corrective government policy, which is beyond the enforcement scope of competition law. Nevertheless, competition authorities in most jurisdictions appear to be playing an important advocacy role in promoting competitive neutrality. Most competition agencies have the right, at their own discretion, to alert policy-makers to the likely impact of their decisions on the competitive landscape. In India, Section 49 of the Competition Act 2002 mandates the CCI to take suitable measures to promotion competition. Under this mandate, CCI organises advocacy workshops with key ministries and departments of the central government and state governments, to highlight the importance of government policies and emphasise how assessment of legislations/policies and sector specific regulations from a competition perspective can help remove competitive distortions and ensure fairness in the market. CCI also organises workshops with various CSOEs on a regular basis to create awareness of competition law andits applicability to SOEs, and hence the need to comply with the law.

Institutional support for competitive neutrality enforcement

1. **Supportive judicial review**: The applicability of competition law to SOEs was supported by the High Court of Delhi in Union of India v. Competition Commission of India,[266] in which the Government of India filed a case against the Competition Commission through the Railway Board of India. The Railway Board contended that running the railroad was a sovereign function and that it was therefore not subject to the Competition Act 2002. The Delhi High Court rejected the plea. The Court recognised ‘Railway’ as an enterprise covered within the ambit of the Competition Act 2002 and held that CCI is empowered to hear complaints against it for alleged abuse of its dominant position in the goods transport sector. It held that:

> the only question then is whether the running of railways ceases to be a business when they are run by Government. There appears to be no good reason to hold that

[266] W.P.(C.) No. 993/2012, available at http://delhicourts.nic.in/FEB12/UOI%20VS%20COMPETITION%20COMMISSION%20OF%20INDIA.pdf.

> it is so. It is the nature of the activity which defines its character. Running of railways is such an activity which comes within the expression 'business'. The fact as to who runs it and with what motive cannot affect it.

It also stated that:

> The fact that the Government runs the railways for providing quick and cheap transport for the people and goods and for strategic reasons will not convert what amounts to carrying on of a business into an activity of the State as a sovereign body.

The High Court also highlighted the clear distinction between sovereign and non-sovereign functions, holding that:

> the primary, inalienable and non-delegable functions of the Government are to be considered as sovereign functions of the Government under Section 2(h) of the Competition Act 2002. Any welfare, commercial and economic functions are not sovereign functions and the state while discharging such functions is as much amenable to the jurisdiction of CCI as any other private entity discharging such functions. Running of Railways is a business activity that comes within the purview of Section 2(h) of the Competition Act, 2002 and hence it is an enterprise.

The High Court interpreted the term ‘inalienable functions’ to mean functions such as the administration of justice, the maintenance of order and repression of crime, the maintenance of foreign affairs, the power to acquire and retain territory, primary and other inalienable functions of a constitutional government like legislative power, the administration of laws and the exercise of the judicial power.

Section 54 of the Competition Act empowers the central government to exempt an enterprise performing a sovereign function on behalf of the central or state government from the application of any provision of the Competition Act. In this regard, the High Court observed that:

> Even in relation to an enterprise which is engaged in activity, including an activity relatable to the sovereign function of the Government, the Central Government may grant exemption only in respect of activity relatable to sovereign functions. Therefore, an enterprise may perform some sovereign functions, while other functions performed by it, and the activities undertaken by it, may not refer to sovereign functions. The exemption under Section 54 could be granted in relation to the activities relatable to sovereign functions of the Government, and not in relation to all the activities of such an enterprise.

2. **Government support**: The Government of India supports the enforcement of competition law to SOEs and the promotion of competitive neutrality. Finance Minister P. Chidambaram, while speaking at the Annual Day of the CCI in May 2013,[267] clearly stated that it was the CCI's duty to ensure competitive neutrality in markets. Competitive neutrality is closely connected with equality of opportunity and freedom of trade, which are fundamental rights under the constitution. He noted that:

   > the most important reason to bring the public sector enterprises under scrutiny for anti-competitive practices is that we increasingly have an open economy where the private sector has to compete with the public sector. A level playing field is in the best interests of the public – the consumers whose interests the Commission is mandated to protect.

   Although all the government's commercial activities come under the provisions of the Competition Act in India, competition law alone is not sufficient to ensure a level playing field for PSUs and private enterprises, which is why policies aimed at achieving competitive neutrality (such as fairer procurement policy) have to play an essential role. Competitive neutrality policies are of particular importance in recently liberalised sectors where they play a crucial role in levelling the playing field between former state monopoly incumbents and private entrants. Equally important is their effective monitoring and enforcement.

3.4 *New initiatives under consideration*

Some other initiatives that could have a considerable positive impact are under consideration in India. The major initiatives are briefly discussed below:

1. **National Competition Policy**: A broad competition policy framework would address competitive distortions in various sectors of the economy. In India, such a broad policy framework called National Competition Policy (NCP) is being considered by the Government of India. The idea of adopting NCP to deal with competition distortions on a systemic basis has been under discussion in the Planning Commission since the Ninth Five Year Plan period. A recommendation was made in the Ninth Plan period to formulate and adopt NCP, which was endorsed by the National Development Council in December 2007. Consequently, the Ministry of Corporate Affairs (MCA) established the Committee on National Competition Policy in June 2011[268] to make the 'culture of competition' an intrinsic part of central, state and local governance. Based on the recommendations of

[267] Annual Day 2013 FM speech , available at: http://www.cci.gov.in/.

[268] Through notification F.No.5/15/2005-IGC/CS dated 8 June 2011, MCA constituted the Committee on National Competition Policy and Related Matters (C-NCP), headed by Mr. Dhanendra Kumar, former Chairperson, CCI.

the Committee as well as consultations with various stakeholders, including state (provincial) governments, various ministries and departments and civil society, the MCA formulated a Draft NCP[269] which is being considered by the Cabinet. Prime Minister Manmohan Singh, speaking at the 3rd BRICS Competition Conference in New Delhi[270] also supported competition policy. He stated that maximising the beneficial effects of markets to meet the challenges of growth, development and poverty reduction requires the development of a sound competition policy.

The NCP seeks to promote the integration of the principles of competition into various government economic policies to maximise the benefits of competition.[271] The basic premise of competition policy is that the government should not restrict market activity any more than is necessary to achieve its social and other goals. Any deviation from the principles of competition should only be to meet desirable social or other national objectives, which should be clearly spelt out. It seeks to strike a balance between competition policy objectives on the one hand, and other policy considerations such as strategic national objectives like social service commitments, on the other hand. The draft NCP[272] calls for a comprehensive competition impact assessment of all proposed and existing laws, regulations and policies to identify those provisions, which cause or have the potential to cause competition distortions. It would help to address numerous policy-induced competition distortions which otherwise could not be checked under the Competition Act.

It is worth noting that here a parallel can be drawn with Australia. The Proposed NCP can be compared to competition policy implemented in Australia in 1995, 20 years after its Competition Law was enacted. A comprehensive review of laws and policies was undertaken and around 1800 laws were modified. The national competition policy of Australia is recognised to have made significant contributions to Australia's welfare by removing unwarranted barriers to competition[273] and delivering substantial benefits to consumers, which far outweighed the transitional or adjustment costs. To implement its competition policy, Australia established the National Competition Council, an independent body responsible to Parliament, which assessed the reform progress since the adoption of the policy. In India too, it is proposed to establish a 'Cabinet Committee on Competition', a high-level body to oversee NCP, which would help align the policies of various ministries and departments to enhance competition in all sectors. In India, it is

[269] Available at: http://www.mca.gov.in/Ministry/pdf/Draft_National_Competition_Policy.pdf.
[270] 21 November 2013, available at: http://www.cci.gov.in/May2011/Home/Speech_PM_3rdBRICS_Nov212013.pdf.
[271] **BS (2004) 'India's uneven playing fields', 2 March:** http://www.business-standard.com/article/opinion/pradeep-s-mehta-india-s-uneven-playing-fields-112121400180_1.html**.**
[272] The Planning Commission in its Manufacturing Plan has also endorsed the proposal for an NCP and recommended several such measures including regulatory impact assessment.
[273] Rennie M. and F. Lindsay (2011), as per comprehensive assessment of the outcomes of Australia's National Competition Policy conducted by the Productivity Commission in 2005.

also proposed to set up a National Competition Policy Council (NCPC) with the appropriate involvement of CCI, the Ministry of Finance, the Planning Commission and key economic ministries to implement the NCP. States in Australia were incentivised to undertake competition reviews and subsequent reforms by transfer of financial resources to reward them for carrying out the process. NCP in India also envisages instituting an incentive scheme, under which financial grants may be given to state governments linked to progress in aligning their policies and laws with NCP principles. The grants could be released based on recommendations received from the NCPC regarding the progress made by the various state governments.

After NCP is approved by the government and if it is effectively implemented across the country, India would be the second country after Australia to implement wide-ranging competition reforms across the country. Among several principles, one of NCP's key principles is competitive neutrality. If this policy is implemented, it may be expected to contribute very significantly to promoting competitive neutrality in Indian markets. However, broad policy initiatives cannot produce meaningful outcomes without full understanding and commitment from stakeholders, including line ministries, regulatory agencies and SOEs. There are concerns that the powers of the proposed Cabinet Committee on Competition may overlap with the Cabinet Committee on Economic Affairs (CCEA), the most important body for making decisions on economic issues. There is also concern that frequent reviewing of laws and policies would create a regulatory and compliance burden for executive bodies in the government and become a hurdle. Further, these bodies may not be equipped with required in-house expertise to carry out such an exercise.

2. **Recommendations of the Financial Sector Legislative Reforms Commission**: The Financial Sector Legislative Reforms Commission (FSLRC) was constituted by the Ministry of Finance in March 2011 to bring the financial sector laws in line with current requirements. There are over 60 Acts and multiple rules and regulations that govern the financial sector. The FSLRC has proposed an Indian Financial Code Bill to pave the way for the creation of a unified financial regulator.[274] Under the proposed regulatory architecture, the Securities and Exchange Board of India (SEBI), Forward Markets Commission (FMC), Insurance Regulatory and Development Authority (IRDA) and Pension Fund Regulatory and Development Authority (PFRDA) would be merged into a new unified agency. The Reserve Bank of India (RBI),[275] however, would continue to exist with modified functions. The Indian financial system has traditionally been dominated by SOEs. Over the last 20 years, however, India has increasingly opened up entry into finance, and a new breed of private

[274] The Financial Sector Legislative Reforms Commission (FSLRC) was asked to comprehensively review and redraft the legislation governing India's financial system. In order to realise its recommendations, the Commission has developed a draft Indian Financial Code Bill, containing 450 clauses and six schedules. Reports in two volumes are available at: http://finmin.nic.in/.

[275] The RBI is the central bank of India.

financial firm has arisen. At present, laws and regulations in India differentiate between different ownership and corporate structures. In its recommendations, the Commission envisaged a regulatory framework where governance standards for regulated entities will not depend on their ownership structure. Thus, a strategy of ownership neutrality, that is equal regulatory and supervisory treatment of a financial firm regardless of whether it is private, public sector, co-operative, Indian or foreign, has been recommended. This can be expected to produce a level playing field in the sector. At present, many public sector financial firms, such as Life Insurance Corporation of India (LIC) and the State Bank of India (SBI), are rooted in a specific law. The Commission recommended that they be converted into companies under the Companies Act 1956 and that their regulatory treatment should be identical to that applicable to all other financial companies. Thus, the recommendations of the Commission are based on competitive neutrality. The report[276] is being considered by the government.

3. **Non-discrimination amongst bidders under the Public Procurement Bill**: The Government of India introduced a Public Procurement Bill[277] in 2012 in order to reform the country's procurement regime, to make it a more open and transparent system. The major objectives of the bill, *inter alia,* include promoting 'fair and equitable treatment of bidders, promoting competition, enhancing efficiency and economy'. The bill comprehensively addresses competition issues by incorporating provisions that would pave the way for a broad range of bidders through: adequate publicity on procurement opportunities and objective pre-qualifying criteria for bidders; framing of objective specifications for items of supply; evaluation of bids based on pre-disclosed criteria; enshrining open competitive bidding as the norm and allowing restricted bidding only in exceptional circumstances; fixing timelines for processing bids to obviate interference in the procurement process; compulsory publishing of tender results; promoting e-procurement, including procurement of standard items through Electronic Reverse Auction; maintaining documentary records of procurement proceedings and retention of records for a fixed period after expiry of the procuring contract, for the sake of transparency; and, most importantly, provision for an independent review and grievance mechanism. Such provisions bring the bill in line with best international practices, as reflected by the WTO Agreement on Government Procurement (GPA) and the United Nations Commission on International Trade Law (UNCITRAL) model law. The proposed changes are expected to go a long way to promote competitively neutral public procurement.

[276] The report is in two volumes, and is available at: http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf and http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf.
[277] The complete bill is available at: http://164.100.24.219/BillsTexts/LSBillTexts/asintroduced/58_2012_LS_EN.pdf. Key highlights are available at: http://www.prsindia.org/billtrack/the-public-procurement-bill-2012-2310/.

4. **Recommendations of the Roongta Panel**: Although SOEs have exhibited a marked improvement in performance, Indian SOEs continue to operate under multiple constraints. The Planning Commission set up an expert panel, headed by Steel Authority of India Limited (SAIL) Chairman S K Roongta in August 2008.[278] It submitted its report in November 2011 recommending a slew of measures to help turn SOEs into drivers of growth. The suggestions were aimed at strengthening the performance, transparency and efficiency of Central SOEs. The panel examined a range of issues related to HR and corporate governance, the MoU mechanism, effective partnerships with the private sector, diversification, mergers and consolidation and technology mapping in CSOEs, and suggested a road map for their development. The recommendations focus on the nature of the relationship with the controlling ministry, the vigilance mechanism, the composition, power and size of boards, the process and time taken for appointments of CMDs and Directors, human resource practices, greater autonomy for entering into joint ventures (JVs), and Research & Development (R&D) in CSOEs. The panel also suggested that the current MoU system needed basic changes to make MoUs more effective for the evaluation of Central SOEs' business performance and also to give direction to their businesses. The MoUs also needed to address the organisation's approach to diversification, acquisition, the formation of JVs, new/strategic businesses, the use of ICT, R&D initiatives, HR development and organisational changes. Instead of having standard parameters applicable for all Central SOEs, currently individual Central SOE boards may formulate MoU proposals with emphasis on the above-mentioned factors. The committee also suggested a redefining of the roles of supervisory bodies like the administrative ministry and vigilance vis-à-vis CSOEs. The Department of Public Enterprises (DPE) has prepared a list of proposals based on the Committee's report, which is being considered by the GoM (group of ministers). Some of the recommendations of the committee are quite ground-breaking and could go a long way towards making CSOEs more competitive. A summary of the recommendations may be found in Appendix III.

5. **Review of investment norms**: At present, there are a number of guidelines issued by the Department of Public Enterprises (DPE) regarding investment by SOEs. Given the current economic scenario, there was a need to develop one set of comprehensive guidelines on the subject. In 2012, the Department of Public Enterprises formed a Committee[279] to review the investment guidelines for investing surplus funds available to CSOEs. The Committee suggested relaxing investment norms for SOEs and allowing them to park their surplus funds in private sector mutual funds to give them some flexibility and provide them with a level playing field vis-à-vis private companies. Currently, they are allowed to

[278] This is why it is referred to as the Roongta Panel.
[279] Headed by Department of Economic Affairs additional secretary Shaktikanta Das.

park their funds only in public sector mutual funds.[280] It is proposed[281] to set a limit for investment in public mutual funds and SOEs could invest the rest of their funds either with private or public sector mutual funds. In addition, they could invite bids from banks for parking their surplus funds. The market regulator Stock Exchange Board of India has also recommended to the government that Navratna and Miniratna CSOEs be allowed to invest their surplus funds in any of the SEBI registered mutual funds. If the proposal is accepted, it will help SOEs get better returns on their funds as they will have a wider choice of investments and will have a level playing field vis-à-vis private companies in this respect. As many SOEs are cash-rich, a sizeable amount of money will flow into private sector funds. Thus, it will also benefit private mutual funds by giving them a level playing field vis-à-vis public mutual funds. Thus this measure will promote competition in mutual funds markets.

4. Advantages and Disadvantages of SOEs in India

SOEs have to fulfil the twin objectives of commercial efficiency and social responsibility. The challenge for the enterprises arises out of the need for them to ensure a reasonable return on investment while discharging their constitutional and social obligations. As wings of the welfare state, SOEs are mandated to act as model employers, and to conduct their business in a transparent manner. Further, they have to protect the interests of all stakeholders such as employees, customers, suppliers, creditors and the community. The environment of competition and globalisation in which public enterprises operate makes these tasks all the more challenging.[282]

Despite the measures taken to make SOEs competitive and to create a level playing field over the last few decades, SOEs still face several advantages and disadvantages. These are briefly enumerated below.

4.1 *Advantages enjoyed by SOEs in India*

State ownership may confer several advantages on SOEs, including:

1. **Monopoly power and exclusive rights**: Governments often grant SOEs exclusive or monopoly rights over activities such as postal services, railways, coal mining, utilities and other universal services. Even with the economy being open to competition for more than

[280] Public sector mutual funds are those in which the Government of India, its financial institutions and public sector banks hold individually or collectively more than 50% of equity or shares.
[281] **The Economic Times (2013), 'Government may allow PSUs to park surplus funds in private sector MFs', 5 December:** http://articles.economictimes.indiatimes.com/2013-06-16/news/40009120_1_cash-rich-psus-surplus-funds-central-psus
[282] Roongta Panel (2011), p. 11.

two decades, SOEs in India still enjoy monopolies in strategic areas like nuclear power and also in areas such as postal services, railways and coal mining. For instance, Coal India Ltd and its subsidiaries accounting for 80 per cent[283] of the country's production enjoy exclusive rights on commercial coal-mining due to nationalisation under the Coal Mines Nationalisation Act.

2. **Concessionary financing**: CSOEs continue to benefit from less visible forms of government financial support.[284] State-owned banks remain major lenders to CSOEs, which in turn can borrow more easily from state-owned banks than other banks. Banks may be more comfortable lending to companies that are state-owned. Moreover, in some, albeit very few cases, CSOE borrowing may still be explicitly guaranteed by the government (based on the public purpose to be served, the credit-worthiness of the company and terms of borrowing).[285] The government also provides both loans and equity finance in some cases through the administrative ministries. Even when there is no explicit government guarantee, investors and lenders believe that an implicit guarantee exists. The anti-competitive effect may often be 'accidental', in that it is perfectly rational for commercial lenders to lower their rates when the debtor is perceived as enjoying state backing. These benefits may artificially lower SOEs' costs and enhance their competitiveness vis-à-vis their privately-owned rivals and help them to stay in business.

3. **Explicit or implicit state guarantees**: Explicit or implicit state guarantees may confer competitive advantage over private rivals as consumers may put greater faith in SOEs' products compared to those of the private sector. For example, under the Life Insurance Corporation Act of 1956, the state-owned Life Insurance Corporation (LIC) enjoys sovereign guarantees, which are alleged to provide undue competitive advantage to LIC. Private players and the insurance regulator, Insurance Regulatory Development Authority (IRDA), have been asking the government to remove sovereign guarantees given to LIC to create a level playing field.

4. **Bailout support and protection from bankruptcy in cases of failure**: SOEs are often protected from two major threats that affect private enterprises: takeover and bankruptcy. SOE bailouts distort the playing field as SOEs get access to cheap funding not

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[283] In an amendment to the Nationalisation Act in 1976, two exceptions were made: i) Coal mining for captive consumption by private companies producing iron and steel; and ii) sub-leasing of coal mining to private parties in isolated small pockets not amenable to economic development and not requiring rail transport. A 1993 amendment further allowed captive mining for generation of power, washing of coal obtained from mines and other end uses as notified by the government from time to time.

[284] World Bank Report 2010.

[285] DPE guidelines stipulate that a CSOE in need of a guarantee must first approach a bank to provide it. If the bank is unable to provide such a guarantee, then the Government of India may be approached. Consultation with the administrative ministry is required and it in turn must consult the MoF. Government guarantees may be given for repayment of loans or share capital, payment of minimum annual dividends, and contracted payments to suppliers

available to their private sector counterparts. There are a variety of bailout policies which are used by the government to bail out SOEs, the most common being direct loans or loan guarantees. The government may provide budgetary support for payment of wages and salaries for certain sick and loss-making SOEs, and may also finance cash components for revival packages through administrative ministries and departments. For example, The Air Corporation Act 1953 – Section 10 provides a legislative framework within which the Government of India may provide funds for capital expenditure as well as potential bailout funds for the national carrier Air India. In 2002, the central government approved a bailout for state carrier Air India and decided to infuse Rs. 300 billion as equity over the next eight years as part of its financial and operational turnaround plan. Another instance is support given in various forms to loss-making state telecom companies MTNL and BSNL. This goes against the principle of competitive neutrality as their private counterparts do not receive the same kind of treatment. These bailouts distort competition in markets as they subsidise the inefficiencies of the recipient firms that expect to be bailed out no matter what. Bailouts also hamper their incentive to innovate and compete in the market. Further, if it is expected that failing firms are likely to be rescued by the government, companies may be encouraged to make overly risky investments, or to adopt lax management practices. More generally, a private firm's incentive to become more efficient in order to cut costs, raise quality or innovate is likely to be dampened if it expects that the resulting competitive advantage will be offset by the granting of aid to its state-owned rivals.

5. **Incumbency advantages**: Some SOEs enjoy incumbency advantages that give them an undue competitive advantage. This may happen in industries that move from monopoly/ dominant operators to a competitive landscape. For instance, in network industries, incumbents may enjoy benefits such as land usage and right of way at a price significantly below that which private competitors would have to pay in similar circumstances. These advantages may artificially lower SOEs' costs and enhance their ability to price more efficiently than competitors. Denial of access to essential facilities such as networks, intellectual property rights and some infrastructure facilities that are objectively necessary to maintain downstream competition has the potential to severely distort competition. An example of market power being exercised by an incumbent is the liberalisation of the rail container transport market, which was earlier exclusively reserved for the Container Corporation of India (CONCOR), an SOE under the Ministry of Railways. CONCOR may enjoy certain advantages over new Container Terminal Operators (CTOs). For example, CTOs have to pay haulage charges on a per train basis as opposed to the credit facility available to CONCOR, which advantages them vis-à-vis private operators.[286] Similarly, in public procurement in recently liberalised markets, the government sometimes demands demonstrable experience in an area to ensure that

[286] CIRC & IICA (2012a), p. 9.

bidders have appropriate expertise, which may advantage incumbents and limit the ability of new entrants to enter such markets.

6. **Captive market**: Sometimes SOEs enjoy a captive market due to favourable government regulations. While CSOEs are free to approach private banks for finance, in practice, they are mandated by the government to park at least 60% of their surplus funds with state-owned banks to shore up banks,[287] which provides a captive market to state-owned banks and means they don't have to compete with private sector banks. Similarly, the requirement that federal government officials travel by a national carrier, such as Air India, provide a captive market to Air India.

7. **Purchase preference in procurement**: As mentioned earlier, general purchase and price preference in favour of SOEs was withdrawn in 2008. However, while withdrawing it, the Department of Public Enterprises Guidelines stipulated that the concerned ministry may independently review or develop preferential purchase policies in their sectors of concern. For example, in 2005, the government approved exclusive purchase preference for pharmaceutical SOEs and their subsidiaries in respect of 102 specified medicines manufactured by them.[288] This was done to provide cheaper medicines to consumers as well as to use SOEs' excess capacity. This policy was extended in 2013[289] for another 5 years in respect of 103 medicines. Similarly, Indian Railways (one of the largest procurers in India) procures high value traction equipment items for ALCO Diesel Locomotives on an annual basis from Bharat Heavy Electrical Limited (an SOE)[290] by using their price list without the normal tendering process. The above examples may give advantage to SOEs vis-à-vis private sector operators in their industries and create distortions in the market.

8. **Captive equity**: Control of SOEs cannot be transferred as easily as privately owned firms. Most, being unlisted, are not subject to the disciplinary effects of capital markets. There may be less pressure on management to operate them efficiently, because they are not subject to threats of takeover.

It must be mentioned that India does not give tax exemptions to SOEs, which are liable to pay taxes like other companies. Rather, as explained in section 2.6, CSOEs pay large amounts of taxes to the Exchequer. Tax collection from the oil sector is higher than the subsidies the sector receives (for selling subsidised fuels). Nearly half the current price of fuel is accounted

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[287] http://www.business-standard.com/article/economy-policy/park-60-surplus-funds-with-psu-banks-govt-to-CSOEs-108111100057_1.html

[288] Purchase Preference Policy for products of Pharma Central Public Sector Enterprises and their subsidiaries: http://pib.nic.in/newsite/erelease.aspx?relid=19212.

[289] Economic Times (2013), 'Government approves Pharma Purchase Policy', 30 October: http://articles.economictimes.indiatimes.com/2013-10-30/news/43528716_1_medicines-CSOEs-hindustan-antibiotics-ltd.

[290] http://www.iica.in/images/Government%20Procurement.pdf.

for by taxes.[291] Thus, there is tax neutrality in India, which fulfils a key part of competitive neutrality.

4.2 *Disadvantages faced by SOEs in India*

Although there has been marked improvement in the performance of CSOEs, they continue to operate under multiple constraints such as:

1. **Implementing multiple and sometimes conflicting objectives**: SOEs in India face many disadvantages that their private counterparts operating in the same markets do not. They need to implement multiple and often conflicting objectives arising out of the multiple roles that the state is expected to perform. For example, as a shareholder, the state would like to ensure profitability. In another equally important role, the state strives to offer universal services to all citizens by charging below cost prices if necessary or extending service into unprofitable areas, ensuring employment, developing infrastructure in backward areas and for other public service reasons. Separation of the various roles is difficult and boundaries tend to blur, posing real challenges for the management of SOEs and making it difficult to prioritise outcomes.

   Such conflicting goals can at times affect overall corporate performance. Decision-making structures are too broad, with most constituents working at cross purposes more often than not, due to an obvious lack of coordination and common drive. The problem multiplies when the perceived final decision-making authority is known to have little knowledge or experience of the sector or is perceived to have vested interests.[292]

2. **Complex institutional and oversight framework and 'over-governance'**: CSOEs are considered to be instruments or agencies of the state[293] under Article 12 of the Indian Constitution (as they have more than 50% government ownership) and hence, are subjected to the same requirements as departments of government. This leads to a plethora of controls, including:
   - **Institutional framework**: Institutional arrangements for exercising the state's ownership rights in India are complex when compared to international practices. The shareholding of the Government of India in CSOEs is held by the President of India ex-officio. The President's powers as a shareholder are delegated to 38 administrative Ministries, each with its own portfolio of CSOEs. The Department of Public Enterprises

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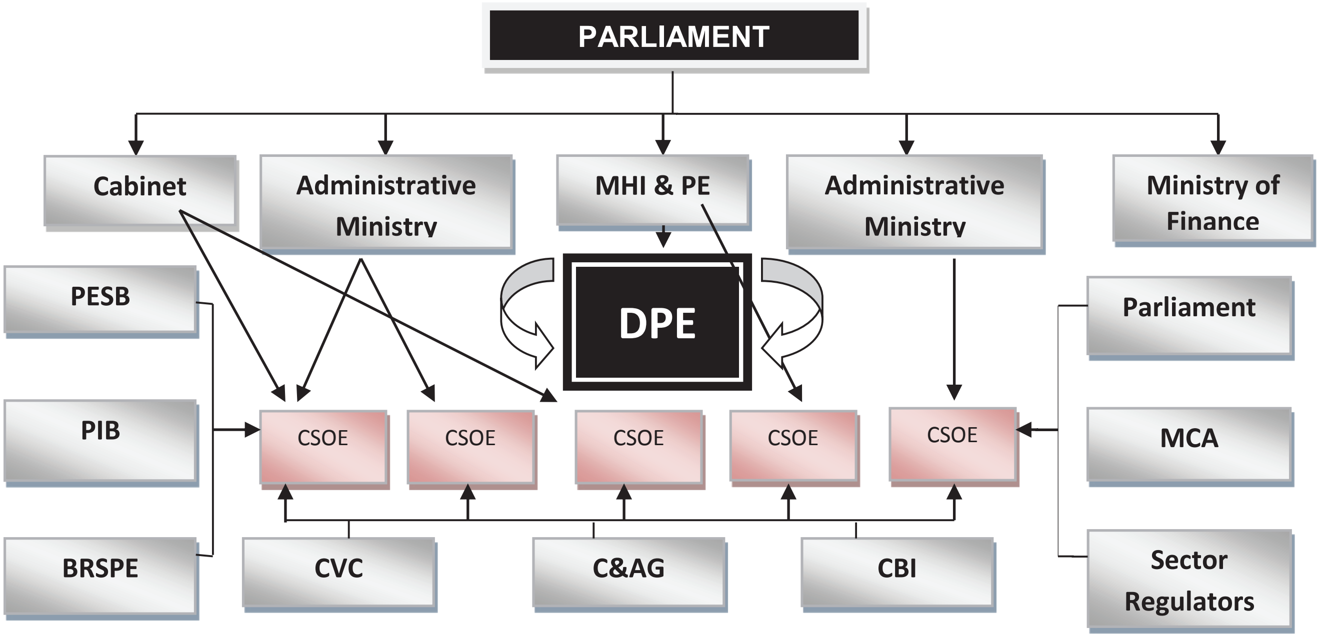
[291] C.P. Chandrasekhar and Jayati Ghosh (2012), 'The great fuel subsidy hoax', *The Business Line*, available at: http://www.thehindubusinessline.com/opinion/columns/c-p-chandrasekhar/article3013252.ece?textsize=large&test=1.
[292] KPMG and ASSOCHAM (2010), p. 14.
[293] Article 12 doesn't expressly state that state-owned enterprises fall within the definition of 'state'. However, there have been a number of decisions where the Supreme Court of India has stated that SOEs fall within the inclusive definition of 'state'.

(DPE) serves as the nodal agency. The DPE sets policies and guidelines for CSOEs and acts as an interface between administrative Ministries and CSOEs. It also manages the MoU system, and supports the board appointment process. The Ministry of Finance (MOF) reviews many finance and investment decisions of CSOEs, as does the Public Investment Board (PIB) for investment plans over Rs. 1 billion. The Cabinet approves a range of major decisions through the High-Powered Committee chaired by the Prime Minister, and finalises the choice of CSOE board directors through the Appointment Committee of Cabinet (ACC).

- **Oversight mechanisms**: CSOEs are accountable to a number of different bodies, including:
  1. **Parliament**: As the main oversight body, a number of parliamentary committees routinely review CSOE's performance and related issues.
  2. **Comptroller and Auditory General (CAG)**: CSOEs with more than 50% state ownership are subject to CAG oversight. An independent body established by the Constitution of India, CAG: i) appoints the statutory auditor and oversees and supplements their work; ii) conducts regular transaction audits of CSOEs; iii) conducts performance audits of CSOEs that focus on particular topics and sectors; and (iv) reports the findings to parliament.
  3. **Central Vigilance Commission (CVC)**: CVC has a mandate to deter corruption and malpractice in CSOEs through monitoring procurement matters and giving clearance for all board positions.
  4. **Judiciary**: CSOEs are subject to judicial review by the Supreme Court of India and the High Courts. They are also subject to writ petitions to the Supreme Court under Article 32 and High Courts under Article 226 of the Constitution.[294]
  5. **RTI Act**: CSOEs have been brought under the ambit of the Right to Information Act (RTI). This means that through a process of appeal, they are subject to authority of Central Information Commission (CIC), the highest appellate body under RTI Act.

[294] The Supreme Court has intervened with the orders of Public Corporations and Undertakings in relation to service matters and also with regard to commercial transactions (Law Commission of India, 145th Report on Article 12 of the Constitution and Public Sector Undertakings).

Institutional and oversight mechanisms for Central SOEs



Source: Adopted from World Bank Report, 2010

The multi-stakeholder structure imposes severe constraints on SOE managers. Complying with the requirements of multiple layers of authority can be quite onerous and time-consuming. A significant proportion of the senior management's time and effort every month must be spent managing parliamentary questions and other queries under RTI. It is estimated that at each and every step of the decision-making process, SOE managers have to consider at least three Cs: CBI, CVC, and CIC. Under such persistent scrutiny, risk-taking and individual initiatives often give way to safety-first and 'not-invented here' (NIH) syndrome. With so many individuals competing for attention, more often than not the results at the operational level are project delays, misaligned supply chains, mismatched cash-flows, lack of professionalism and poor accountability. In fact, the effectiveness of CSOEs' CEOs may lie overwhelmingly in managing the relations with the various arms of government. According to the Roongta Panel,[295] which has also dealt with the issue of over-governance:

> Compliance to summons from various quarters comes at a heavy cost of time and money. Over-governance, in turn, promotes conservative, cautious and risk-averse organisational culture, with procedures being paramount and outcomes becoming secondary.

It is noteworthy that the multiple oversight mechanisms mean that audit standards for CSOEs are more stringent than for private companies, given that CSOEs are required to

[295] Planning Commission (2011), 'Report of Panel of Experts on Reforms in Central Public Sector Enterprises (CPSEs)', known as the Roongta Panel.

conduct audits in accordance with CAG requirements in addition to company standards. The fact that CSOEs can coordinate all of these audits and prepare a report on time is a notable achievement. There is concern that CAG supplementary audits may duplicate the work of statutory auditors and contribute to delays in finalising accounts, resulting in non-compliance with the requirements for publishing audited results[296] and risk aversion in commercial decision-making. Similarly, there have been complaints that, in view of exposure to market forces, many DPE guidelines are overly prescriptive and serve to reduce, rather than enhance, the competitiveness of SOEs.[297] Worse, even bona fide commercial decisions are subject to writ jurisdiction – a weakness that litigious suppliers and customers tend to exploit. A committee led by Justice Mohan in 1999 noted that both parliament and the general public expect a level of granularity far beyond what the average shareholder expects of private companies, which tilts the competitive environment against SOEs.

3. **Lack of managerial autonomy**: Autonomy implies ‘freedom to act’ and is related to ‘freedom in internal management’. SOEs need to run their operations on commercial lines to compete with the private sector. Many SOEs have substantial autonomy but also face restrictions on their managerial freedom due to obligations to follow a plethora of rules and regulations (such as various Department of Enterprises guidelines). This affects their ability to compete with the private sector, which is not bound by such restrictions and can take quick decisions as required by the market. Many of Air India’s current problems appear to be due to government involvement in its day-to-day functioning, such as its inability to buy aircraft without clearances, withdrawal of flights from profitable routes, grant of bilateral rights to foreign carriers in excess of actual requirements, and muddled mergers. It took decades, for example, for nationalised banks to do something even as basic as computerising their operations, which many feared would lead to mass retrenchment. The composition of management boards is decided by the government, and this is a major problem which undermines the principle of autonomy. The management board may tilt the balance of decision-making on policy matters greatly in favour of the government, further reducing the autonomy of SOEs. With the economy opening up and competition coming from Indian and overseas players, flexible organisation structures and agile processes are needed to be suitably responsive to opportunities and threats.

4. **Uneconomic pricing decisions**: Pricing is one of the core drivers of competitiveness and market share, yet many CSOEs have little or no real control over it. Again, this is mainly because they are treated as an arm of the government, rather than as independent firms that must compete with the private sector. Socio-economic considerations, such as the impact of a price rise on the poor, or on inflation more generally, take priority over basic

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[296] This was suggested by the Arjun Sengupta Committee Report and the J. J. Irani Committee Report.
[297] World Bank (2010).

issues such as cost and profitability. To compensate, the government has, over a period of decades, spun an elaborate web of price controls and subsidies. However, this system of 'controlled prices' has done the SOEs more harm than good. The woes of India's giant oil-marketing companies – bound as they are by regulated retail prices that are often out of sync with global prices – are too well-known to repeat, but the fertilisers sector, where government-notified sale prices for urea and decontrolled phosphate and potassium fertilisers have long been held below the costs of production, is not doing much better either. Although this gap is partly covered by subsidies, it has benefited neither SOE producers (who, with little incentive to do so, have not invested in new fertilisers plants in years), nor even consumers. Even the few attempts at price reforms, such as those in the oil and gas sector, have so far been limited. The government has only partly executed a recommendation to free up petroleum prices, allowing for parity pricing at the 'refinery gate', that is at the point at which refiners sell to marketing companies. The end result is a 'burden-sharing' arrangement across the supply chain, and persistent under-recoveries, which adversely affects SOEs' bottom lines.

5. **Guidelines on procurement by CSOEs:** The government has delegated substantial powers to CSOEs under the Maharatna, Navratna and Miniratna scheme in areas such as capital expenditure, investments and joint venture formation, in order to give a boost to their capacity-building and to improve their competitiveness.[298] However, CSOEs are still considered as an extended arm of the government and are required to follow a large numbers of rules and procedures, which inhibit their flexibility to operate in a competitive environment. One such issue relates to procurement. Procurement procedures in CSOEs are regulated by their own Purchase Manual generally based on General Financial Rules (GFR) as well as Central Vigilance Commission (CVC) guidelines on procurement. Following these guidelines is subjected to internal audit, Committee of Directors audit and Comptroller and Auditor General (CAG) audit. One of the CVC guidelines relating to procurement stipulates that no negotiation can be carried out even with the lowest bidder, called L1, except in certain exceptional circumstances. This limits the negotiating power of the procuring SOEs both in terms of cost and time. On the other hand, private players are free to adopt a negotiated route to get the best time and cost offers. This adversely affects the competitiveness of SOEs in markets in which they are competing with private players.

6. **Development and management of manpower**: It is important for any organisation to have the right pool of resources. It is also vital for SOEs to recruit talent, train manpower, match skills and job responsibilities, and keep the workforce motivated in a fast-changing economic environment. SOEs are exposed to a talent war of sorts, with the potential and existing workforce exposed to multiple opportunities in the private sector, both globally

[298] CIRC & IICA (2012c).

and in India. Thus, SOEs need to upscale their investments in people-related interventions as their competitors do. As discussed earlier, several measures taken to improve manpower management in SOEs have led to some improvement. However, personnel management in the public sector is still beset with problems, such as the following:

- Human resource policies hinder CSOEs and reduce their competitiveness. They are set by the Government of India through DPE guidelines and provide detailed guidance on pay and benefits for senior and supervisory employees. Delegation of powers to Navratnas and Miniratnas has provided some flexibility, but this delegation does not extend to rules for pay and benefits and in practice, the Government of India tends to be limited by the administrative Ministries and Department of Public Enterprises (DPE). DPE guidelines set the salaries for the Chairman and Managing Director (CMD) and functional directors based on the category of the company.
- State regulation of the compensation structure in Indian SOEs has fallen behind the private sector. With economic liberalisation taking root in India, the differences between public sector enterprises and their corporate competitors are widening. Thus, SOEs are finding it difficult to retain their pool of best talent.
- Performance management systems in most SOEs are based on years of experience rather than individual performance against identified goals. Consequently, the motivation to outperform is low and competitive spirit is lacking within SOEs. Young people's perceptions of SOE operations and inability to contribute to overall professional development leads to an ageing workforce in SOEs.
- Unlike their private counterparts, SOES do not have the freedom to hire and fire in response to changing circumstances, even if they are suffering losses. They have to implement wage structures in line with other SOEs, irrespective of conditions in their sector.

7. **Huge wage bills**: Many CSOEs face huge wage bills[299] due to their inability to fire employees even when facing losses. For example, one of the key problems facing the state telecom companies MTNL and BSNL is rising expenditure combined with a sharp decline in revenue in a highly competitive market. The principal reason for the increase in expenditure is the large legacy workforce, as a result of which employee expenses are currently around 50% of revenues for BSNL and 103% for MTNL. This compares to an industry average of less than 5%. Pensions amount to 86% of salary costs at present and are expected to exceed salary costs by 2014-15. The private sector, however, has complete freedom to hire and fire according to their needs.[300]

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[299] FE (2014), 'Fixing bloated wage bills is key to making PSUs viable', 10 January: http://www.financialexpress.com/news/fixing-bloated-wage-bills-is-key-to-making-psus-viable/1217458.

300 Minister of State for Communications and IT, Killi Kruparani, written reply to the Rajya Sabha (Upper House) on 6 December 2013.

8. **Lack of financial autonomy**: Most SOEs do not enjoy financial independence unlike their private counterparts, which often leads to delays in decision-making. Formulating a business case for fund-raising and seeking approvals can be an arduous task for them. A number of agencies are involved in the planning and control of financial management of public enterprises in the country, such as the Board of Management, Administrative Ministry, Ministry of Finance, Bureau of Public Enterprises, Planning Commission and Public Investment Board.

9. **Regulatory restrictions**: Several regulatory restrictions may reduce the operating freedom of SOEs. For example, the Department of Public Enterprises' guidelines issued in 2008 and 2009 impose restrictions on the investment of surplus funds. All SOEs are advised to invest their surplus funds with one or more state-owned banks in the larger interest of the system, to spread resources among the state-owned banks, to not invite competitive bids for bulk deposits[301] (neither from state-owned banks or private sector banks) and to not withdraw funds from banks prematurely to deposit them elsewhere. These guidelines restrict the freedom of CSOEs to deploy their funds so as to get the best returns for their surplus funds. They also limit competition among the banks by prohibiting the invitation of competitive bids, which results in banks continuing to retain business obtained earlier without making any effort.

10. **Technology management issues**: SOEs operate in the context of considerable technological obsolescence and unavailability of skilled labour. Many still operate with legacy systems that are largely paper-based. While some major SOEs have been identified as leading spenders in information technology (IT) systems, they have a long way to go before they can be considered on a par with their competitors. SOEs are also constrained by a lack of employees with 'best-in-class' IT-related skill sets, as the majority of the talent pool is absorbed by the private sector and global players. Consequently, they are also dependent on outsourced agencies to execute their projects. These factors may adversely impact their productivity and competiveness in highly competitive markets, including global markets.[302]

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[301] To avoid undesirable competition amongst banks leading to arbitrary and artificial hikes in deposit rates which would have consequences for the economy as a whole.
[302] CCI and KPMG (2013), p. 18.

5. Areas to be Addressed

From the earlier analysis, it is clear that over the years, several measures have been taken to improve the efficiency and performance of SOEs, which play a crucial role in shaping the modern Indian economy. Yet, governance challenges prevail and further reforms are required. Governance reforms in SOEs are politically contentious and challenging to implement, because the government does not want to cede control of these national assets, and other entrenched groups may oppose or resist reforms. This section briefly analyses some of the critical areas that need to be addressed in order to make SOEs competitive and to develop competitively neutral markets in India.

1. **Reorganising the state's ownership role**: International experience suggests that the way in which the state organises and exercises its ownership rights is central to improving the governance of SOEs. The complex governance and oversight system resulting from state ownership does not allow for the separation of ownership and policy functions, which may create conflicts of interest. The predominant view is that, at present, the balance tilts heavily towards over-regulation of SOEs through the involvement of administrative ministries in day-to-day matters and through other checks and balances, which together strangle the companies and minimise entrepreneurial or commercial decision-making. The challenge is how to make the ownership arrangements more effective so that they achieve an appropriate balance between autonomy and accountability. This could be achieved by:[303]
    - reforming ownership arrangements to focus the role of administrative ministries on policy-making, limiting their day-to-day role in commercial decision-making, and giving boards greater decision-making powers in practice. Moving to a more centralised ownership model in the longer-term would also be helpful.
    - improving the ways in which the Government of India exercises its key ownership functions, in particular enhancing transparency in the board appointment process and improving performance monitoring. The main objective should be to bring greater clarity to the state's ownership role, in particular to distinguish between commercial decisions, which should be left to the board, and management and policy decisions, which require government intervention. It is noteworthy that the Roongta Panel has recommended revisiting the issue of whether SOEs should be considered part of the 'state',[304] given the multiple oversight mechanisms that this status imposes on SOEs.
    - considering, as the Roongta Panel has suggested, a shift towards a single holding structure. Such a model will mean creating a sovereign wealth fund, and at the same time, will effectively shift the government's role to that of a venture capitalist, with a range of investments in SOEs.

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[303] *Ibid*, p. 2.

[304] Since SOEs are considered part of the 'state', they are subjected to multiple oversight mechanisms, which adversely affect their functioning and ability to take decisions and competitiveness.

2. **Institutional separation between policy making, operations and regulation**: An established principle of competition (and also of good governance) is that policy-making, regulation and operation of a business should be separate and not managed by a common set of people.[305] A clear separation is a fundamental prerequisite for ensuring a level playing field and for avoiding competitive distortions. However, there are instances where the boundaries have been blurred or not respected, and this has led to distortions within some sectors. For example, the Department of Telecom (DoT), which decides on telecom policy, also oversees the Telecom Regulatory Authority of India (TRAI) and owns two telecom SOEs: Bharat Sanchar Nigam Ltd (BSNL) and Mahanagar Telephone Nigam Ltd (MTNL). This combination of policy-making, regulatory oversight and ownership of market players is inconsistent with competitive neutrality principles. When TRAI was first established, there were many disputes between it and DoT, and some matters even went to court. Another instance is in the field of distance education, where the Distance Education Council (DEC) has been mandated to prescribe guidelines for determining standards for distance education in India. All centres, institutions and directorates that impart education through the distance mode have to have their programmes recognised and approved by DEC. However, the regulator, DEC, is headed by the Vice Chancellor of IGNOU, which is the largest operator in the distance education market. Similarly, in the electricity value chain, there is a need to ensure effective unbundling and complete ownership and management separation of competitive and monopolistic segments. An added dimension to this problem is that the Electricity Regulatory Commissions also function under the Power Ministry at central and state government levels, which prevents the application of sound principles of regulatory law and policy. The state should be neutral or maintain an arms-length relationship and should be distinct from the regulated utilities. Furthermore, the segments should not be unbundled on paper only. The separation of ownership and management would bring in the critical separation of powers that would enable the distinct units to function neutrally.

   The independence of sectoral regulators ensures that the interests of various stakeholders are considered in formulating and implementing regulation and prevents regulatory capture by vested interests. This is especially important in India, where the state is a major player in the utilities sector. Clear laws and regulations should be developed to protect the independence of the regulators, especially in relation to line ministries. The report of the Financial Sector Legislative Reforms Commission (FSLRC) recommends physical, legal and administrative separation of the regulator from the government, implying that regulators must have independent infrastructure and personnel. FSRLC also recommends independent sourcing of finances from sources, such as fees to ensure financial independence. Following these recommendations would go a

[305] CIRC & IICA (2012a).

long way in ensuring the independence of regulators and creating a level playing in the relevant markets.

3. **Risk aversion resulting from over-governance**: The Roongta Panel noted that over-governance leading to excessive regulation and accountability measures has resulted in a culture that discourages prudential risk-taking and breeds indecision within SOEs. Boards have been given substantial autonomy over the last few years but this may not be used.[306] The prevailing culture dictates that SOEs consult with administrative ministries on matters that would generally not require such consultations. Management is often reluctant to make basic operational decisions, pushing all such decisions up to the board, to a much greater extent than is common in well-governed companies in the private sector. As a consequence, the frequency and duration of board meetings is higher than warranted, with boards spending more time on operational details than on strategy formulation and other higher level matters. A new model focusing on the arms-length relationships between the government and SOEs needs to be developed to address the concerns of over-governance. Organisations have to make a distinction between accountability for procedures/process and accountability for agreed performance/results. The issue of over-governance needs to be tackled by bringing in a focus on performance-related accountability so that SOEs become more proactive and results-oriented.

4. **Balance autonomy and accountability by professionalising SOE boards**: The 2010 World Bank study on CSOEs suggests that while SOE boards have come a long way in becoming more professional, there is still substantial room for improvement, particularly in the area of vesting boards with greater decision-making authority while ensuring responsible and accountable behaviour, so as to avoid political interference in their day-to-day functioning. Delegation of decision-making powers through Department of Public Enterprises (DPE) guidelines has helped empower the boards of CSOEs, particularly in Navratna and Miniratna companies. In practice, however, anecdotal evidence and stakeholder discussions suggest that there are several areas where CSOE boards have little or no say. These areas include the appointment and removal of the CEO and directors, and to a lesser extent, strategy formulation, both of which are legitimate and fundamental board functions.[307] Further, there is an urgent need to disengage management autonomy from board composition to achieve a clear and unambiguous growth map. Particularly in the case of Navratnas, Miniratnas and other profit-making companies, boards could be made more effective by bringing in independent directors from the private sector, empowering boards with greater decision-making authority while ensuring responsible behaviour through integrity and accountability mechanisms, strengthening audit committees, introducing performance-based board evaluation and remuneration practices, and making board development and leadership programmes mandatory. As

[306] KPMG & CCI (2013).
[307] Som (2013).

recommended by the Roongta Panel, SOE Boards need to evolve a system of annual self-evaluation. The process could begin with Maharatna and Navratna companies.

5. **Independent auditing**: CSOEs have a three-tier audit system, including: i) internal audit; ii) statutory audit; and iii) Comptroller and Auditor General (CAG) audit. An independent and effective audit committee is one of the most important tools to ensure sound financial reporting and risk management, and to strengthen accountability. The Stock Exchange Board of India's Clause 49, the Companies Act and the Department of Public Enterprises' Guidelines on Corporate Governance all require setting up of an independent and qualified audit committee, and spell out its role and powers in detail. Large CSOEs and other major listed companies have advanced systems and in some cases, are Systems Applications Products (SAP) compliant, with integrated risk management systems in place, but for the vast majority of CSOEs the internal control function appears to be in its early stage.[308] Recent CAG reports have indicated that some SOEs have deficiencies concerning financial reporting, including audit reports and disclosures. Some of these deficiencies have raised questions about the quality of audits within SOEs. As recommended by Guidelines on Corporate Governance, SOEs should consider adopting a risk-based approach to internal audits and supplementing in-house internal audit functions with external service providers in areas requiring specialist skills. In the future, CSOEs should be encouraged to develop and strengthen their own robust internal controls and audit function. The development of adequate internal controls and an audit function should be made a minimum mandatory requirement in the CG Guidelines. All CSOEs should be required to establish audit committees and ensure they have sufficient numbers of independent directors with adequate knowledge of financial and other relevant matters. CAG may consider doing concurrent financial audits or resorting to supplementary audits on an exceptional rather than a routine basis. Overall performance should be the guiding criterion rather than the review of individual commercial decision-making.[309]

6. **Enhancing transparency and disclosure**: As noted by the 2010 World Bank report, CSOE disclosure standards are comparable to those in many OECD countries. The Right to Information Act (RTI) Act has pushed the frontier even further on transparency and accountability. At the aggregate level, both the Comptroller General of India (CAG) and the Department of Enterprises (DPE) submit comprehensive annual performance reports to parliament and the public. The RTI Act, which covers the transparency and accountability of the public sector, requires administrative ministries to disclose a range of information about CSOEs on their websites. Implementing these disclosure requirements however can be a major challenge for many CSOEs, particularly in light of relatively weak internal audit and control functions, lack of guidance on disclosure (particularly for non-listed firms), and potential duplication and delays in the various CSOE

[308] *Ibid.*
[309] World Bank (2010).

audits.[310] Enhancing transparency and disclosures in practice is a key challenge which needs to be addressed.

7. **Operational autonomy**: The current tendering process for SOEs is tedious and very time-consuming. SOEs do not have the flexibility to contact the leading supplier or contractor and discuss terms. Also once a contractor is shortlisted based on the lowest financial bid (L1), SOEs are unable to further negotiate to gain a competitive rate. Further, compulsion to buy raw materials and key equipment from the lowest bidder at times results in compromises on quality and efficiency of delivery. The above constraints may result in a comparative disadvantage for SOEs vis-à-vis their private counterparts. With the increasing competition between public and private sector, it is time to consider granting operational flexibility to SOEs to meet their procurement needs, which may include negotiations with the lowest bidder (L1) and entering into long-term contracts. Similarly, private companies often resort to spot sales and purchases, and offer discounts to try to capture the market. These practices are particularly prevalent in the international market. However, such practices may conflict with Central Vigilance Commissioner (CVC) guidelines and norms set by the government, which need to be re-examined considering the highly dynamic and competitive global environment. Oversight should become outcome-based rather than procedure-based, as the latter creates a culture of risk aversion and limits operational freedom and may adversely impact competitiveness.

8. **Loss-making CSOEs**: The adverse effects of resisting changing times and technology on the fortunes of an enterprise can be witnessed in the high number of sick CSOEs, although the number has substantially reduced over the last decade. The feasibility of turnaround of sick PSEs needs to be extensively analysed before any measures are adopted. If there is a risk or low probability of turnaround, loss making CSOEs must be considered for disinvestment. If there is no intention to privatise such CSOEs, the government may consider selling loss-making CSOEs through auction to other CSOEs, so that profit-making CSOEs could bid, especially to create new businesses, leveraging their excellent infrastructure.[311]

9. **Human resource management issues**: Although SOEs are taking steps to better manage human resource challenges, there are still several areas of concern. Currently, most SOEs are reactive in progressing towards succession planning.[312] As most leaders of SOEs are nearing retirement, it is imperative that SOEs proactively groom next-level leaders not only for all critical roles, but also for specialised jobs and future strategies of SOEs. SOE Boards should be empowered and the multiple layers that inevitably delay the selection process eliminated. When it comes to Chairman and Managing Director (CMD) succession,

[310] KPMG & CII (2013), p. 17.
[311] As recommended by the Roongta Panel.
[312] KPMG (2013).

SOEs should start the process at least a year in advance. It is essential that SOEs adopt an organisation-wide approach to meet training needs, which will facilitate capacity development for crucial requirements and increase workforce productivity.

10. **Reforms of state-level SOEs**: A lion's share of the investment in SOEs has gone into infrastructure projects, also called 'public utilities'. Although these enterprises are often monopolies, they operate at a price disadvantage as they have to work under an administered price regime. Despite rises in inputs costs, prices of the goods and services of these enterprises have not been correspondingly raised for years, and has been one of the reasons for financial losses. The National Survey on State Level Public Enterprises (2007-08)[313] showed that whenever reforms have been undertaken, largely these have showed results. As these SOEs play an important role in infrastructure sectors, there is a need to implement comprehensive reforms to make them competitive and provide a level playing field between SOEs and the private sector.

6. Conclusion

It is clear that for both political and economic reasons, governments will remain major owners of productive assets in a number of economies for years to come.[314] In India too, despite two decades of liberalisation and partial divestment by governments, the state continues to hold non-trivial and often controlling stakes in SOEs. SOEs continue to remain a dominant feature of the economy in India and have played their part during the last few decades in meeting the social objectives that were envisioned when they were established. However, due to the opening of most sectors to private sector enterprises, SOEs are now competing with the private sector in most markets. Therefore, the issue of competitive neutrality – providing a level playing field so that both can compete on merit without any advantage or disadvantage due to ownership – becomes crucial.

Given the continuing and significant presence of SOEs in diverse sectors of the economy, it is important to ensure that to the greatest possible extent, yet consistent with their public service responsibilities, they are subject to similar competition discipline as private enterprises. The governance framework for CSOEs in India is consistent with several aspects of international good practice.[315] Substantial progress has been made in removing barriers to competition, reducing government financial support, and listing CSOEs on the capital markets. Almost all CSOEs are corporatised and come under the same laws as private sector companies. Nevertheless, there are still some important differences between CSOEs and the private sector which may distort competition and market incentives. These include certain

[313] Department of Public Enterprises, New Delhi, available at: http://dpeslpe.gov.in/DOC/SLPE_Vol-I.pdf.
[314] Som 2013.
[315] World Bank (2010).

legal and financial privileges that favour SOEs on the one hand and social obligations and human resource challenges that constrain them on the other.[316] Furthermore, despite the far-reaching reforms of the last few decades, the work culture in SOEs still seems to be driven by the need to comply with procedures rather than to show results. SOEs remain shrouded in red tape, doctored pricing systems, multi-layered governance structures and depleting workforce. This delays decision-making and exacts a toll on their operational performance, putting them at a disadvantage vis-à-vis the private sector. Thus, governance challenges still remain and further reforms are needed to build on the substantial gains that have already been achieved.

The integration of the Indian economy with global markets has resulted in new opportunities as well as throwing up several challenges for SOEs. The foremost challenge for Indian SOEs today is to increase their competitiveness to deal with market forces.[317] The attainment of technological dynamism and international competitiveness requires that enterprises are able to swiftly respond to fast-changing external conditions that have become characteristic of today's industrial world.[318] The imperative is therefore to truly unshackle SOEs, and force them to either sink or swim with the tide. This was recently succinctly stated by PM Dr. Manmohan Singh:[319]

> By virtue of their ownership, they have been shielded from competition and have long enjoyed captive markets. A crucial issue is the exposure of these firms to competition. The government may own a public sector firm and exercise the normal rights of ownership. This does not mean it should shelter it from competition as well. Unfortunately, government ownership inevitably brings with it a bureaucratic style of decision-making and the end result is that the enterprise cannot compete in a market populated by equals. The solution lies in giving public sector firms greater functional autonomy and freeing them from bureaucratic control, and not in tolerating a slip in their competitiveness and then shielding them from competition.

Numerous commissions and expert groups have studied the issues in depth and offered recommendations for improvement. The challenge going forward, therefore, is one of implementation.[320] Reforms aimed at improving governance and increasing CSOE autonomy such as board appointment and empowerment and separation of ownership from policy functions can facilitate broader policy reforms aimed at increasing market discipline through exposure to competition, tightening of budget constraints, listing of CSOEs on the stock exchange and disinvesting through strategic sales and public-private partnerships. Market

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[316] CCI and KPMG (2013), p. 15.
[317] Statement by President of India, Pranab Mukherjee, Global PSE summit organised by the Indian Confederation of Indian Industry (CII) in collaboration with Department of Public Enterprises on 13 December 2013.
[318] Industrial Policy Statement 1991.
[319] Inaugural Speech at BRICS International Competition Conference, at New Delhi, 21 November 2013.
[320] World Bank (2010), p. 4.

discipline in turn puts pressure on companies to pursue sound business strategies and good governance.[321] This helps promote a level playing field for both SOEs and private players.

India is in the process of establishing a strong competition law regime and the equal treatment of SOEs with private sector enterprises under the Competition Act 2002 will play a vital role in ensuring a level playing field in the market economy. As government policies can be a source of competition distortions and a lack of competitive neutrality, there is a need for government policies outside the competition law framework to work in tandem so as to achieve the goal of competitively neutral markets. Competition assessments of legislation and sector-specific regulations can help in the removal of competitive advantages, although this is considered to be outside the scope of competition law enforcement. However, global experience shows that competition authorities can effectively contribute to the attainment of competitive neutrality through advocacy. Countries such as Australia, Hungary and South Korea have benefited from their competition authorities playing such a role. CCI is endeavouring to contribute to the goal of competitive neutrality not only through enforcement but also through active advocacy. As noted by Gaur:[322]

> The CCI needs to assume the role of a competition advocate, working proactively to bring about government policies that lower barriers to entry and promote deregulation and trade liberalisation, and competition in the market place. For that it needs to acquire credibility and reputation as an effective and impartial advocate for competition. Enforcement is also strengthened by active advocacy, and advocacy cannot truly be effective in the absence of effective enforcement. It is imperative that the CCI successfully prosecutes cases that are widely viewed as beneficial to society, whether they involve destructive cartels, high-profile anti-competitive mergers, or abusive conduct by notorious dominant firms.

As far as the government is concerned, a major challenge is finding a balance between the state's responsibility to actively exercise its ownership functions, such as the nomination and election of the board, while refraining from imposing undue political interference in the management of SOEs. Another important challenge is ensuring that there is a level playing field in markets in which private sector companies compete with state-owned enterprises and that the government does not distort competition while using its regulatory or supervisory powers.

[321] World Bank (2010).
[322] Gaur (2012), p. 178.

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Appendix I

Level of Empowerment: CSOE Autonomy based on their Classification

Category of CSOEs	Capital Expenditure	Joint Ventures & Subsidiaries	Organisational Restructuring & Human Resource Management	Resource Mobilisation	Mergers & Acquisitions
Maharatna	No cap on capital investments.	Can establish financial joint ventures, wholly owned subsidiaries and undertake M&A in India or abroad, with the condition that equity should be limited to i) INR 5,000 cr. in any single project, ii) 15 per cent of the net worth of the CSOE in one project, and iii) 30 per cent of the net worth of the CSOE in all joint ventures/ subsidiaries put together communication does not stop at level 1 customers.	Empowered to undertake organisational restructuring including creation of profit canters, opening of offices in India and abroad, establishing new activity centres. Can create and make appointments for all positions up to E-9 level. Also empowered to delegate Human Resource Management related powers (appointments, transfer, posting, etc.) to below board level executives.	Can raise debt from domestic capital and international market, post approval of RBI/Department of Economic Affairs.	Can undertake M&As subject to i) it should be in accordance with the growth plan & in the core functioning area of the CSOE, ii) the Cabinet Committee on Economic Affairs (CCEA) to be kept informed in case of investments abroad.
Navratna	No cap on capital investments.	Can establish financial joint ventures and wholly-owned subsidiaries in India or abroad, with the condition that equity should be limited to i) INR 1,000 cr. in any single project, ii) 15 per cent of the net worth of the CSOE in	Empowered to undertake organisational restructuring including creation of profit centres, opening of offices in India and abroad, establishing new activity centres.	Can raise debt from domestic capital and international market, post approval of RBI/Department of Economic Affairs.	Can undertake M&As subject to i) it should be in accordance with the growth plan & in the core functioning area of the CSOE, (ii) conditions/ limits would be as in the case of establishing joint

		one project, and iii) 30 per cent of the net worth of the CSOE in all joint ventures/ subsidiaries put together.	Can create and make appointments for all positions up to E-6 level. Also empowered to delegate Human Resource Management related powers (appointments, transfer, posting).		ventures/ subsidiaries, and (iii) CCEA to be kept informed in case of investments abroad
Miniratna I	Can incur investments up to INR 500 cr. or equal to net worth, whichever is lower.	Can establish joint ventures and wholly owned subsidiaries in India, with the condition that equity should be limited to i) INR 500 cr. in any single project, ii) 15 per cent of the net worth of the CSOE in one project, and iii) 30 per cent of the net worth of the CSOE in all joint ventures/ subsidiaries put together.	The Board can delegate the powers pertaining Human Resource Management (appointments, transfer, posting, etc.) of below Board level executives to sub-committees of the Board or to executives of the CSOE	N/A	Can undertake M&As subject to i) it should be in accordance with the growth plan & in the core functioning area of the CSOE, (ii) conditions/ limits would be as in the case of establishing joint ventures/ subsidiaries, and (iii) CCEA to be kept informed in case of investments abroad
Miniratna II	Can incur investments up to INR 250 cr. or 50 per cent of net worth, whichever is lower.	Can establish joint ventures and wholly owned subsidiaries in India, with the condition that equity should be limited to i) INR 250 cr. in any single project, ii) 15 per cent of the net worth of the CSOE in one project, and iii) 30 per cent of the net worth of the CSOE in all joint ventures/ subsidiaries put together.	The Board can delegate powers pertaining to Human Resource Management (appointments, transfer, posting) of below Board level executives to sub-committees of the Board or to executives of the CSOE.	N/A	Can undertake M&As subject to i) it should be in accordance with the growth plan & in the core functioning area of the CSOE, (ii) conditions/ limits would be as in the case of establishing joint ventures/ subsidiaries, and (iii) CCEA to be kept informed in case of investments abroad.

Source: Adopted from KPMG, 'Public Sector Enterprises: Transformation, Competitiveness & Sustainability'

Appendix II

Key highlights of the Department of Enterprise (DPE)'s Corporate Guidelines for SOEs

- To ensure independence of the Board, the CSOEs should have an optimum combination of Functional, Nominee and Independent Directors with the number of Functional Directors not exceeding 50% of the actual strength of the Board and the number of Nominee Directors appointed by Government being restricted to a maximum of two. For CSOEs listed on the stock exchange and whose Board is headed by an Executive Chairman, the number of Independent Directors should comprise at least 50% of Board Members, while for all other CSOEs (i.e. not listed CSOEs or CSOEs listed on stock exchange with non-executive Chairman), at least one-third of the Board Members will comprise Independent Directors
- The Board should meet at least once every quarter and reports on financial performance should be circulated to each Board member along with the agenda well in advance.
- As part of the Board level committees, an independent Audit committee should be constituted with a minimum of 3 members with two-third of the members being Independent Directors to primarily oversee the enterprise's financial reporting process and disclosure of its financial information to ensure that the financial statements are correct, sufficient and credible.
- The CSOEs shall submit quarterly progress reports on the status of compliance to Corporate Governance Guidelines, within 15 days from the close of each quarter, to respective Administrative Ministries / Departments.
- A separate section on Corporate Governance, with details of compliance, is to be published in annual accounts. The enterprise is also required to obtain a certificate from the auditor/ practicing Company Secretary regarding compliance to conditions of the Corporate Governance as stipulated in the guidelines. The certificate is to be sent to all shareholders annually and is also to be included in the annual report.

Appendix III

Recommendations of the Roongta Panel

- It should be made mandatory for every CSOE to constitute a Strategy and Business Development Committee of the Board, which should meet at least twice a year to agree on plans and proposals and evaluate progress at the year end. The recommendations of the Committee should be approved by the Board.
- CSOE Boards should evolve a system of annual self-evaluations, which could first begin with Maharatna/Navratna companies.
- Structure of the Board need to have fifty percent of the Board members, as independent directors, as per the present guidelines.
- There should be a separation in the role of a Government nominee on the Board from their position in the Government of India (viz, as Joint Secretary / Additional Secretary to the Government of India). On all issues where the Government has no specific views, the role of the Government Directors should be akin to those of the Independent Directors. Any official views of the Government could be conveyed in writing to the CSOE Board or get recorded accordingly by the Government Directors during the Board meetings.
- In the Annual Performance Appraisal of Government of Directors, certain weight should be assigned to their performance as Director(s) on the Boards of CSOE(s). One objective measure of the same could be the overall performance of the concerned CSOE during the year.
- The DPE/PSEB should formulate a panel of approved names out of which independent directors may be appointed. This list should be updated every six months. Apart from the administrative Ministries, CSOE Boards may also suggest names for consideration as independent directors. The full-time CEOs from successful enterprises willing to serve in these positions may also be considered for appointment as independent directors on the CSOE Boards, provided there is no conflict of interests. CMDs and whole-time Directors of CSOEs should also be considered for independent director positions in other enterprises, including in other CSOEs. The names recommended by the nomination committee and approved by the Board may be sent by the CMD directly to the Search Committee.
- There is an urgent need to streamline the process of appointments of CMDs and whole time Directors on CSOE Boards. There is also an urgent need to streamline the system of obtaining vigilance clearances.
- There is need to segregate the appointment of CMDs of 'Maharatna and Navratna CSOEs' from the current process. These CSOEs are critical to the economy and need to have a system that builds in appropriate succession planning, apart from speedy appointments so that performance of these companies does not get hampered. The criteria for selection should have greater emphasis on the leadership qualities, strategic

thinking, capabilities to manage external environment etc. apart from the domain / sectoral expertise.

- An update should be provided in every session of Parliament on the vacant positions of CMDs of CSOEs, to create transparency around this important aspect.
- The tenure of CMDs / Directors in CSOEs should be a minimum of 3 years, irrespective of their age at the time of first appointment.
- The fear psychosis relating to vigilance functions is leading to risk aversion in CSOEs and inhibiting their performance. A vigilance frame-work that recognises that vigilance as a function is to be primarily performed by the management needs to be evolved in consultation with CVC.
- The C&AG should bring out an annual report about best practices prevailing in diverse fields in different CSOEs, as observed in the process of performing the 'Oversight Functions' and the same should be shared with other CSOEs. This will not only help the CSOEs to learn from each other to improve their performances, but will create a positive mind-set about the role of C&AG among the CSOEs.

SOE Regulation in Malaysia and the Competitive Neutrality Principle

Wan Khatina Nawawi and Saovanee Chan Somchit

1. Introduction

This chapter was prepared as a case study on Malaysia for the UNCTAD Competitive Neutrality research project. While the overall research project recognises the implementation of a competitive neutrality framework as a method to regulate commercial activities by government bodies or enterprises (including state-owned enterprises, SOEs), this study examines how Malaysia regulates its SOEs[323] in the absence of such an explicit framework.

The chapter first discusses, in Section 2, SOEs in Malaysia in the context of their historical development, the privatisation programme, the various types of SOEs currently in existence, and their fiscal implications. Section 3 discusses in greater detail the commercial banking sector, an industry which consists of players with different ownership structures, and how the sector is being regulated. Section 4 reviews the various policy and regulatory mechanisms that are enforced by the authorities to regulate SOEs' commercial activities. Of particular significance is the enforcement of a generic competition law as of 1 January 2012. The chapter concludes by examining whether existing policy and regulatory mechanisms are adequate for regulating SOEs in Malaysia and whether competitive neutrality can be achieved in such a regulatory environment. It is emphasised that the competitive neutrality framework, especially as it has been developed and implemented in developed countries such as the EU and Australia, may not be appropriate for the current economic conditions and development in Malaysia, but that the development and evolution of the regulatory environment so far highlights the possibility of moving towards adopting such a framework when conditions permit.

[323] The later part of the chapter will highlight the fact that SOEs are known by many terms in Malaysia including non-financial public enterprises (NFPEs), government-linked investment companies (GLICs), and government-linked companies (GLCs). However, for ease of discussion, the term SOEs will be used in this study.

2. SOEs in Malaysia

2.1 *Historical development of SOEs and their privatisation in Malaysia*

The historical development of SOEs in the country can be traced all the way back to British Malaya, or pre-independence days. They were then known as 'agency houses', and were involved in key sectors of the Malayan economy, notably plantation, tin mining and commercial trading. Agency houses in the rubber industry such as Harrisons & Crosfield, Boustead-Buttery, Guthrie and Sime Darby owned and managed vast tracts of plantation land, which they managed to secure from their close relationship with the British Civil Service in Malaya.[324]

Post-independence saw the Federal Constitution empowering the state governments' land and water management. This means that state governments could enact laws to regulate agriculture, mining, fisheries and forestry within their state boundaries. This resulted in many of these state governments taking steps to establish state economic development corporations (SEDCs) to manage their natural resources.[325]

Following the 13 May 1969 racial riots in Kuala Lumpur, in 1970 the federal government developed and introduced the 'National Economic Policy' (NEP), which was an economic programme of affirmative action for the Bumiputeras.[326] The NEP had broad socio-economic objectives including increasing domestic participation, especially the Bumiputeras' participation, in the economy. The NEP set target equity ownership levels of 30% foreign, 40% other Malaysian and 30% Bumiputera to be reached by 1990. The establishment and development of SOEs were considered crucial to achieve NEP targets. Indeed, the SOEs were established at a rate of over 100 SOEs annually by the mid-1970s.[327]

In 1983, the Malaysian government embarked on a privatisation programme as part of the wider Malaysia Incorporated (Malaysia Inc.) policy.[328] The Malaysia Inc. policy was developed

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[324] See Putucheary, J. J. (2004), 'Ownership and Control in the Malayan Economy', INSAN, Kuala Lumpur. In the early 1970s to 1980s, the Malaysian government took control over many of these agency houses. These GLCs are now owned by the GLICs, for example, Boustead is a GLC under the Armed Forces Fund Board or Lembaga Tabung Angkatan Tentera (LTAT), a GLIC; Sime Darby is a conglomerate GLC under Permodalan Nasional Berhad (PNB), a GLIC incorporated in 1978 as part of the NEP.

[325] There is more information on SEDCs in the sub-section below.

[326] Translated as 'Sons of the soil', Bumiputeras are the indigenous groups in Malaysia, of which the Malay are the predominant group.

[327] Adam, Christopher, William Cavendish and Percy S. Mistry (1992), *Adjusting Privatization: Case Studies from Developing Countries*, James Currey, Heinemann and Ian Randle Publishers, London, UK, Portsmouth, USA and Kingston, Jamaica.

[328] At the outset it should be noted that the concept of privatisation in Malaysia is broadly defined to include partial divestitures in which the government may still own majority shares in the entities. Tan, Jeff (2010), *Privatization in Malaysia: Regulation, Rent-seeking and Policy Failure*, Routledge, Oxford, UK.

to promote the increasing role of the private sector in the Malaysian economy.[329] In 1985, the government launched the Guidelines on Privatisation which had five main objectives:

- To facilitate economic growth;
- To relieve the financial and administrative burden of the government;
- To improve efficiency and productivity;
- To reduce the size and presence of the public sector in the economy; and
- To help meet the restructuring objective of the National Development Policy.

MAS, the national airline, was the first SOE to be privatised under the programme. MAS was chosen as it was already a body incorporated under the Companies Act 1964 and so would not have to go through the corporatisation process, seen as an important initial step to ready an SOE to become a private corporation.[330]

Subsequently in 1991, the government introduced the Privatisation Master Plan (PMP) to guide the implementation of the programme. The work on privatisation was to take place in stages (See Diagram 1). The plan represented a new approach to development which complemented the earlier policies, notably the 1983 Malaysian Inc. policy, and was developed to underscore the increased role of the private sector in the development of the Malaysian economy. The government's intention under the PMP was to reduce its presence in the economy, decrease both the level and scope of public spending and allow market forces to govern economic activities.

The initial stage of privatisation (1991-1995) encompassed all sectors of the economy but was focused mainly on the construction sector (22.5% of total projects) and the manufacturing sector (15.2%).[331] The major projects privatised during that period included the Light Rail Transit System (LRT) in Kuala Lumpur, the National Sports Complex, the national automotive company (Perusahan Otomobil Nasional Berhad, PROTON), the Second Link to Singapore and the national electricity company (Tenaga Nasional Berhad, TNB). These projects were selected because of the importance of the goods and services involved and the strategic nature of these sectors.

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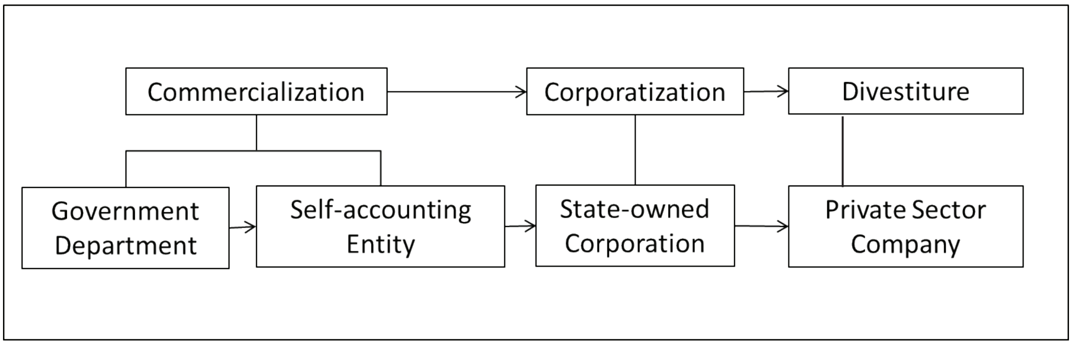
[329] Malaysia (1991), *Privatization Master Plan*, Government Printer, Kuala Lumpur, Malaysia (PMP).
[330] Mokhtar, Khairiah Salwa (2008), *Privatising Malaysia Airlines: A Policy Transfer Approach*, Penerbit Universiti Kebangsaan Malaysia, Bangi, Malaysia.
[331] 7MP (1996).

Diagram 1: Stages of privatisation in Malaysia



Source: PMP (1991)

This privatisation trajectory faced a minor setback during the 1997/1998 Asian Financial Crisis, which forced Malaysia into a period of crisis management, stabilisation and further restructuring. The recovery was a result of concerted effort by the private and public sector, and resulted in a stronger corporate sector through financial and operational restructuring and improved corporate governance. The period and the subsequent recovery saw a greater role for the government in economic management, including in the banking and corporate sectors, which resulted in several large and strategic corporations being renationalised or coming back under government ownership and control. In Section 3, we discuss in detail the commercial banking sector in Malaysia, its structure and performance, as well as the sector regulatory landscape.

After the 1997/1998 Asian Financial Crisis, many high profile SOEs were restructured. For example, in December 2000, the government through the Minister of Finance Incorporated (MOF Inc.), bought back the 29.09% shares in MAS which had earlier been sold to Naluri (a private corporation), and the government pension fund acquired the 9.1% shares sold earlier to Brunei Investment Agency. The government also nationalised previously private corporations including Renong Berhad, which became part of the UEM Group Berhad, and Syarikat Prasarana Negara Berhad, the national infrastructure company.[332]

Another important outcome of the 1997/98 Asian Financial Crisis was the implementation of the National Economic Recovery plan (NERP), which saw the establishment of Pengurusan Danaharta Nasional Berhad (Danaharta) and Danamodal Nasional Berhad (Danamodal) in

[332] UEM Group Berhad was initially known as the United Engineers Group Berhad and was awarded the North-South Expressway concession in 1986. Before Renong Berhad became the organisation's largest shareholder in 1991, the conglomerate also acquired a range of infrastructure-based businesses including cement (CIMA, Cement Industries of Malaysia Berhad), construction (Ho Hup Construction Company Berhad) and waste management (Kualiti Alam Sdn Bhd). Post-Asian Financial Crisis, Renong Berhad's wholly-owned subsidiary, Projek Usahasama Transit Ringan Automatik Sdn Bhd (PUTRA) defaulted in its interest payment (see the company's website: www.uem.com.my). In 2002, the government's Corporate Debt Restructuring Committee (CDRC) restructured PUTRA's debts and Syarikat Prasarana later took over the company's assets and operations (together with other 'failed' transportation projects). UEM Group Berhad has since become a wholly-owned subsidiary of Khazanah Nasional Berhad and undergone major restructuring programmes.

June and August 1998 respectively.[333] With the deepening financial crisis, the main objective of the NERP was to maintain financial stability. To deal with the rising non-performing loans (NPLs), the NERP established Danaharta and Danamodal as asset management companies (AMC) to acquire NPLs from financial institutions and to recapitalise the flailing financial institutions. Danaharta embarked on a system-wide NPL carve-up and made offers to all financial institutions in Malaysia, regardless of their ownership. These included finance companies, development banks as well as locally incorporated foreign banks. Evidence shows that there was no discrimination between SOE and non-SOE financial institutions. By all accounts, the AMC model allowed for a systematic recovery of many large financial institutions and the financial system as a whole. This initiative, alongside improvements in the economic climate, avoided a large-scale banking crisis in Malaysia during that period.

2.2 *Types of SOE in Malaysia*

Currently, SOEs in Malaysia are no longer confined in terms of their activities and customers or clients. They also provide commercial goods and services, often in the same markets as non-SOEs as in the banking and finance, manufacturing, leisure and tourism and agriculture sectors. Examples of SOEs in these sectors include Maybank, Chemical Company of Malaysia Berhad, Rangkaian Hotel Seri Malaysia Sdn. Bhd. and TH Plantations. Their customers and clients have become more diverse, ranging from the government, other SOEs, non-SOEs and the general public. Some SOEs have also internationalised their commercial activities by operating in regional and international markets.

There are several types of SOEs in Malaysia. Government ownership in these SOEs can be both direct and indirect by either the federal or the state government. At the federal level, SOES can be directly owned by a government ministry, department or agency; or indirectly owned through a government-linked investment company, statutory body and the public sector agency. Definitions and examples of each of these SOEs include:

- **Companies under direct ownership of the government**: MOF Inc. is a corporate body established under the Minister of Finance (Incorporated) Act 1957 (Act 375)[334] and considered to be a separate legal entity from the Ministry of Finance (MOF). MOF Inc. owns equity shares for the government in these SOEs: Penang Port, the Multimedia

[333] The Pengurusan Danaharta Nasional Berhad Act 1998 was passed by Parliament in 1998 to provide special laws in the public interest for the acquisition, management, financing and disposition of assets and liabilities by Pengurusan Danaharta Nasional Berhad. In view of Danaharta's closure in 2005, all subsidiaries, except for Danaharta Managers, Danaharta Urus and Danaharta Hartanah were voluntarily liquidated. These three companies remain active as they are owners of residual recovery assets which are managed by Prokhas Sdn Bhd – later sold to the Minister of Finance Incorporated.

[334] All of the federal government legislation cited in this report is available on the e-Federal Gazette portal.

Development Corporation, and the national railway company (Keretapi Tanah Melayu Berhad, KTMB).

- **Government-linked companies (GLCs)**: The term GLC was first used in the GLC Transformation (GLCT) programme.[335] According to the GLCT Manual, GLCs are defined by control rather than by ownership. An entity is considered a GLC when the government has some form of control, either directly or indirectly through a government-linked investment company (GLIC). Control, in turn, is defined as the ability to appoint members of the Board and senior management and to make decisions. If the government was to own a small stake in a listed company through one of its investment holding companies but could not exert any control, the entity would not be deemed a GLC, even though there is government ownership. Examples of GLCs include Maybank, Tenaga Nasional Berhad (TNB), and MAS.

- **Government-linked investment companies (GLICs)**: GLICs are investment holding companies which hold stakes in the GLCs. There are two distinct categories of GLICs: those fully owned by the government such as MOF Inc. and 'privately funded' GLICs where the government plays an important statutory or guarantor role. The latter category includes the Employees Provident Fund (EPF) and the Armed Forces Fund Board (LTAT). Each of these GLICs has its respective shareholders and hence has different mandates and investment strategies. For example, MOF Inc. is responsible for holding investments on behalf of the government and for managing these investments in line with the national interest. The EPF is an agency under the Ministry of Finance and was formed by the Employees Provident Fund Act 1991 (Act 452) to manage the savings of its members who are private and non-pensionable public sector employees.[336] The monthly contributions from its members are invested in approved financial instruments which include equities in companies.

- **Statutory bodies**: Some SOEs are statutory bodies that have been created by special Acts of Parliament which allow them to undertake commercial activities. They report to government ministers, who are then accountable to parliament for these SOEs' performance. Unlike government departments, they are independent legal entities and have flexibility in their day-to-day administrative matters. An example would be PETRONAS which operates under the terms of the Petroleum Development Act 1974 (Act 144) and is currently a fully integrated oil and gas corporation.[337]

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[335] Although the term was initially meant only for the GLCT programme, there is now widespread use of the term, often erroneously. There is a misconception that the GLC universe encompasses all other SOEs. See the PCG's website for more information.
[336] See the EPF's website for more information.
[337] See Petronas' website for more information.

Similar forms of SOEs are replicated at the state level as state governments maintain direct equity stakes or equity stakes through their investment holding companies. As mentioned in the previous section, these companies are known as state economic development corporations (SEDCs). While in the past these SEDCs were mainly involved in the natural resources and agriculture sectors, they have since invested in other sectors of the economy. Additionally, their activities and operations are no longer confined to their respective state boundaries as some of them have actively participated in national and international markets.

One example is the Johor Corporation (JCorp), a market-driven SOE of the Johor government.[338] Established in 1968, it is to date one of Malaysia's leading business conglomerates, comprising more than 280 member companies and employing more than 65,000 employees in Malaysia and regionally. Seven of its member entities are listed on the Malaysian stock exchange, with one public limited company listed in Papua New Guinea, as well as the London Stock Exchange. JCorp is a highly diversified with business in the palm oil sector, healthcare, food and beverage, poultry and poultry products, industrial and commercial property, shipping and logistics (see Diagram A1 in the Appendix for JCorp's corporate structure). JCorp is also a statutory body. As such, it is required to comply with specific regulations and laws, namely the Johor Corporation Enactment No. 4 of 1968 (as amended by Enactment No. 5 of 1995) and the Incorporation (State Legislatures Competency) Act 1962 (Act 380),[339] in addition to the other laws and regulations that also govern SOEs.

2.3 *Fiscal implications of SOEs*

Competitive neutrality can be substantially achieved through the privatisation and corporatisation of SOEs. To a certain extent, this has been actively undertaken by the Malaysian government as highlighted earlier. Indeed, between 1983 and 2005, the privatisation programme generated RM1,536.5 million in the sale of assets and RM4,940.2 million in the sale of equity, with savings amounting to RM153,960.8 million for capital expenditure and RM7,747.1 million for operating expenditure. A total of 113,220 public sector employees were transferred to the private sector.

One of the potential net competitive advantages that SOEs enjoy, which is a key concern in the competitive neutrality framework, is the pecuniary benefits conferred to SOEs by the government. These could be in many forms such as subsidies received from the government, tax exemptions or favourable tax rates, and concessionary capitals and guarantees.

In the case of Malaysia, the government may partially subsidise some of the universal service obligations undertaken by SOEs to provide goods and services to underserved communities

[338] Johor is one of the southern states in West Malaysia bordering Singapore.
[339] See JCorp's website.

in the country. For example, MAS provides rural air services in East Malaysia through its wholly-owned subsidiary, MASwings. Between 2008 and 2010, the government provided RM150 million in subsidies to the entity.[340] In certain industries, such as the telecommunications industry, all market players, regardless of their ownership structure, are required by law to contribute to the universal service fund administered by the sector regulator. However, they all also have access to this fund on a reimbursement basis. Every year, Petronas subsidises the gas prices for all power generator companies and Tenaga Nasional Berhad (TNB), the power transmission SOE, to the value of between RM8 billion and RM12 billion. It must be noted that this subsidy benefits both the SOE (TNB) and non-SOEs (the independent power producers, IPPs). The government regulates the electricity tariff rates and thus the subsidies are directly passed on to both industrial and household consumers.[341] In a sense, the pricing policy of some of these SOEs may not take into account the full production costs as doing so would result in higher prices or tariffs for consumers.

The government also provides guarantees on some of the SOEs' debts, but as a percentage of total debt, these are decreasing: in 2012, 16.7% of the total SOEs' medium- and long-term debt (RM11.59 billion of RM69.41 billion) monitored by the MOF was guaranteed by the government.[342] The 2012 Auditor General's Report highlighted that between 2009 and 2011, 18 of the SOEs audited had received loans from the government.[343] The subsequent sections will highlight that those SOEs receiving concessionary capitals and guarantees are subject to additional legislative requirements to ensure public accountability.

SOEs in other countries may be exempted from paying tax and/or dividends to the government. However, this is not the case in Malaysia as its SOEs contribute significantly to government revenue through dividend payment to the government (as a shareholder) and through various forms of tax including corporate tax, petroleum tax and petroleum export duties. For example, Khazanah Nasional Berhad and PETRONAS paid RM3 billion and RM28 billion worth of dividend respectively to the government in 2012 (between 2009 and 2011, they each paid dividends worth RM3.6 billion and RM105.3 billion respectively). Between 2009 and 2011, both Khazanah Nasional Berhad and PETRONAS also paid RM3.8 billion and RM80.2 billion worth of corporate tax to the government. The national oil and gas company

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340 The government informed the parliament that it had provided a total of RM400 million in subsidies for the provision of rural air services in East Malaysia. This included RM250 million of subsidies to AirAsia, a non-SOE airline, between 2006 and 2007 (Borneo Post (2011), 'Govt questioned on AirAsia, MASwings subsidies', The Borneo Post online, 9 November 2011, available at: http://www.theborneopost.com/2011/11/09/govt-questioned-on-airasia-maswings-subsidies/).

341 Jala, Idris (2013), 'The truth about subsidies', *The Star online*, 16 September: http://www.thestar.com.my/Business/Business-News/2013/09/16/The-truth-about-subsidies-We-must-get-our-facts-right-when-talking-about-them.aspx.

342 Treasury (2012), 'Economic Report 2012/2013', Treasury of Malaysia, Government Printer, Kuala Lumpur, Malaysia. The MOF did not provide specific examples of SOEs with guaranteed government debts. The data was taken from the national debt summary provided in the Treasury Economic Report 2012/2013.

343 AG (2013). 'Laporan Ketua Negara Persekutuan 2012', National Audit Department Malaysia, Putrajaya, Malaysia.

also contributes to other forms of government revenue including petroleum tax and export duties. The total figures for these were RM31.96 billion and RM2.39 billion respectively in 2012.[344]

3. Industry Case Study: The Commercial Banking Sector in Malaysia

The banking sector in Malaysia includes players that are both state- and non-state (private) owned as well as local and foreign. This section reviews the structure and performance of the Malaysian banking sector overall, as well as the regulatory environment for the sector.

3.1 *The Malaysian banking sector: structure and performance*

This section focuses on the structure and performance of the Malaysian banking sector. Using a top-down approach, we begin with a review of the overall banking sector, followed by details focused on the industry players. Although we provide some detail about the overall banking sector, which consists of commercial, Islamic and investment banks (see Table 1 below), the focus of this case study will be on the commercial banking sector.

Table 1: Types of banks in Malaysia and their activities

Type of bank	Activities
Commercial banks	• These are entities performing the basic banking activities of deposit taking, financing, remittance and trade financing.
Islamic banks	• Islamic banking was introduced in Malaysia in 1983 through the Islamic Banking Act 1983. It was initially limited to two Islamic banks, Bank Islam (M) Bhd and Bank Muamalat (M) Bhd. It was only in 1993 that commercial banks were allowed to conduct Islamic banking activities.
Investment banks	• Key activities of investment banks are corporate finance advice and consultation on matters relating to corporate and investment transactions. • At the end of 2005, BNM and the Securities Commission, Malaysia issued a guideline for investment banks with regards to activities that overlap between these two regulators.

Source: BNM

[344] See Treasury (2012).

Banking institutions in Malaysia

As of June 2013, there are 62 banking institutions licensed to provide financial services in Malaysia: 15 investment banks, 27 commercial banks and 20 Islamic banks (see Table A1 in the Appendix). Of the 27 commercial banks, eight are domestic banks whilst 19 are locally incorporated foreign banks. In terms of ownership, of the eight domestic banks, four of these have some form of indirect government ownership, through one of the various GLICs (see Table A2 in the Appendix).

The current structure of the Malaysian banking sector has been significantly shaped by the Central Bank of Malaysia, Bank Negara Malaysia (BNM)'s, bank merger initiatives, which can be traced back to the 1980s. The process of getting banks to merge began in earnest in the mid-1980s due to the global economic recession which also affected the domestic economy. The government's policy then was to allow market forces to drive bank mergers. However, this was not fruitful as the number of banking institutions did not reduce significantly between 1980 and 1990 (see Table 2).[345]

Table 2: Number of banking institutions in Malaysia between 1980 and 2011

	1980	**1990**	**1997**	**1999**	**2011**	**2013**
Commercial banks:	38	38	35	34	24	27
Domestic	*21*	*22*	*22*	*21*	*8*	*8*
Foreign	*17*	*16*	*13*	*13*	*16*	*19*
Finance companies	47	45	39	25	-	
Merchant banks	12	12	12	12	15	
Islamic banks	-	-	-	-	17	
Total	**97**	**95**	**86**	**71**	**56**	

Source: BNM

Meanwhile, the banking crisis in the mid-1980s forced a number of weak commercial banks and financial institutions to the brink of bankruptcy, as these institutions were saddled with huge non-performing loans (NPLs) resulting from the 1985/1986 recession. In view of the severity of the banking crisis and to maintain the integrity of public savings and the stability of the financial system, BNM was compelled to implement a rescue scheme. This involved the acquisition of shares in some of the weaker commercial banks by BNM and the absorption of the assets and liabilities of the insolvent finance companies by stronger finance companies. As a result, the number of commercial banks and finance companies was reduced to 35 and 39 respectively in 1997 from 38 and 47 respectively in 1980.

[345] 'Bank Negara explains rationale for bank mergers: Article extracted from The Star, Malaysia', 11 August 1999. Source: http://www.mir.com.my/lb/econ_plan/contents/press_release/110899merge.htm.

In the wake of the 1997/1998 Asian Financial Crisis and to avert another costly banking rescue scheme, BNM adopted early measures to safeguard the banking institutions, and announced a merger programme for domestic banking institutions on 29 July 1999. The merger plan initially called for the merger of 21 commercial banks, 12 investment banks and 25 finance companies into six core financial groups, namely Malayan Banking Berhad (Maybank), Bumiputra-Commerce Bank Berhad, Multi-Purpose Bank Berhad, Perwira Affin Bank Berhad, Public Bank Berhad and Southern Bank Berhad. However, the plan did not sit well with the market players and BNM subsequently announced its revised plan to merge the 58 banking institutions into 10 anchor banks. In addition to the original six core banks, the four other appointed anchor banks were RHB Bank Berhad, Hong Leong Bank Berhad, Arab-Malaysian Bank Berhad and EON Bank Berhad. Southern Bank was subsequently acquired by the CIMB Group in March 2006, while EON Bank was acquired by Hong Leong Group in 2011, thus reducing the number of core banks to the current eight.

Indeed, the consolidation of these domestic banks significantly altered the market structure of the local banking industry by drastically reducing the number of local players, leading to a marked increase in market concentration. The bank merger process has also resulted in the creation of several leading financial holding companies, and consequently, a wide spectrum of bank sizes.

The banking sector in Malaysia has been growing steadily in the last 10 years. The sector has shown a healthy growth in pre-tax profit from RM3 billion in 2004 to RM7.7 billion in 2012 driven by higher trading and investment profits, and higher fee income. Indeed, this surpassed the pre-global financial crisis pre-tax profit of RM5.2 billion in 2007. Return on equity (ROE) stood at 17.5% in 2012, lower than the pre-financial crisis high of 19.7% in 2007, reflecting higher equity level in the banks.[346]

Banking sector industry players

Among the listed financial services groups, the Maybank Group leads the industry both in terms of total assets and in terms of market capitalisation. Maybank's total assets in the Financial Year 2012 (FY2012) came to RM494.9 billion. This is followed by the CIMB Group (RM364.6 billion) and Public Bank (RM274.6 billion). RHB Capital is the fourth largest listed financial group (RM189.1 billion), while AMMB Holdings occupies the fifth spot with total assets of RM127 billion. Collectively, the total assets of the nine listed financial services groups exceed RM1.3 trillion. The Maybank Group alone accounted for more than a quarter of total assets at 26.4%, while CIMB Group accounted for slightly more than one-fifth of total assets for FY2012.

[346] Bank Negara Malaysia, 'Quarterly Statistical Bulletin for Fourth Quarter of 2012', Kuala Lumpur, Malaysia.

Maybank and CIMB, the top two financial groups in the country, are already regional players. Maybank has more than 450 offices in 17 countries and territories apart from Malaysia, including Singapore, Cambodia, China, United Kingdom and United States. Similarly, CIMB operates both in the retail and investment banking markets in 17 countries, including the ASEAN countries, Sri Lanka, China, Australia, United Kingdom and United States. CIMB is also the fifth largest universal banking group in ASEAN by total assets. The other local banking groups in Malaysia operate primarily in the Malaysian market, with limited exposure overseas.

In terms of the commercial banking market's total assets, Public Bank is the second largest after Maybank, followed by CIMB in third place. RHB is ranked as the fourth largest commercial bank with total assets of RM141.1 billion, while AmBank occupies the fifth spot. However, with the acquisition of EON Capital's assets and liabilities by Hong Leong Bank in 2011, this enlarged entity is now the fourth largest banking group in Malaysia. The smallest commercial bank operating in Malaysia is the Industrial and Commercial Bank of China (ICBC), with an asset base of RM1 billion. On the basis of market capitalisation at the end of March 2013, Maybank also leads the banking sector with a total market capitalisation of RM91.04 billion.

In looking at the market share of commercial banks, we categorised the market both by total loans and total deposits – the two key functions of a commercial bank. The top 10 commercial banks, if calculated based on the loans market, collectively account for approximately 93% of loans totalling RM883.3 billion in the banking system in FY2012. Maybank accounted for almost a quarter of total loans, while Public Bank is the second largest player in the loans market, accounting for close to 18% of total loans (see Table 3).

Table 3: Market share of loans of top 10 commercial banking groups in Malaysia in FY2012

	Commercial banking groups	**Gross loans RM billion**	**% of total loans**
1	Maybank	311.8	24.1
2	Public Bank	196.1	17.7
3	CIMB	208.3	14.5
4	RHB	84.0	9.5
5	AmBank	65.9	7.5
6	Hong Leong Bank	38.6	4.4
7	OCBC	36.1	4.1
8	UOB	35.2	4.0
9	HSBC	35.0	4.0
10	Standard Chartered	28.8	3.3
	Total loans – Top 10	**822.0**	**93.1**

Source: Banks' financial statements

In the deposits market, the top 10 players make up 85% of the total deposits of RM1.1 billion in the banking system in FY2012. As in the loans market, the top three players in the deposits market are Maybank, Public Bank and CIMB, which collectively account for about half of total deposits. Maybank has the highest market share of 20.8% of total deposits, followed by CIMB (15.5%) and Public Bank (14%). The list of top 10 players in the deposits market is shown in Table 4.

Table 4: Market share of deposits of top 10 commercial banking groups in FY2012

	Commercial banking groups	**Customer deposits RM billion**	**% of total deposits**
1	Maybank	236.9	20.8
2	Public Bank	176.9	15.5
3	CIMB	159.6	14.0
4	RHB	92.4	8.1
5	Hong Leong Bank	69.7	6.1
6	AmBank	69.4	6.1
7	HSBC	48.3	4.2
8	OCBC	43.2	3.8
9	UOB	39.0	3.4
10	Standard Chartered	34.3	3.0
	Total customer deposits – Top 10	**969.7**	**85.0**

Source: Banks' financial statements

Based on these figures, we note that the top commercial banks in terms of market share are local banks, but not specifically banks with government shareholdings or ownership. Both Public Bank and Hong Leong Bank do not have any government shareholdings but are both high-performing, profitable banks with large market shares in the consumer banking sector in Malaysia. This is primarily because these banks specifically focus on core business areas such as consumer and retail commercial loans. Public Bank, for example, focuses heavily on home mortgages, passenger vehicle hire purchase, vehicle financing and personal financing. These two banks are also recognised for their prudent management, consistently strong balance sheets, strong corporate governance and effective corporate culture.

3.2 *Regulatory landscape of the Malaysian banking sector*

Background

The rapid growth of the Malaysian economy during the early 1980s played an important role not only in the commercial development of financial institutions in Malaysia, but also contributed to the development of the regulatory landscape of the Malaysian banking industry. Apart from the commercial growth of financial institutions, this period also saw the introduction of a variety of products and services to the market. In 1983, for example, the banking industry witnessed the introduction of Islamic banking in Malaysia. The availability of technology changed the way banking transactions were done with the delivery of financial services shifting from a manual to an electronic-based delivery system. This affected not only transactions with clients but also business and operational transactions within and between financial institutions. In addition to the changes in structure, products and business processes, political events such as the September 2011 (9/11) terrorist attack, and economic events such as the 1997/1998 Asian Financial Crisis and the recent US subprime crisis, also affected the way the banking system works and contributed to the regulatory landscape that we see today.

Regulatory framework

As well as being regulated by 'general' legislation that also governs activities in other sectors or industries, Malaysian banks are regulated by specific legislation under the purview of BNM.[347] BNM's powers and authorities are set out in the Central Bank of Malaysia Act 1958. The key functions of BNM are listed as:

- To be the sole issuing and distributing authority of currency in Malaysia;
- To maintain adequate external reserves to safeguard the value and stability of the currency;
- To be the banker and financial adviser to the government;
- To influence the credit situation to the advantage of Malaysia;
- To lay down policies intended to promote sound monetary stability and a strong financial structure to enhance economic growth in Malaysia;
- To be the lender of last resort;
- To issue licences for banking activities; and
- To regulate licensed banks and their activities.

As a whole, BNM regulates all banking activities in Malaysia except for offshore banking activities which are regulated by the Labuan Financial Services Authority (LOFSA). Overall, all banks, regardless of their ownership structures, are regulated by the Financial Services Act 2013 (FSA2013) and the Islamic Financial Services Act 2013 (IFSA2013). These two pieces of legislation encompass all commercial, investment and Islamic banks. The only type of financial institution that is excluded from FSA2013 are development financial institutions (DFIs), which are instead governed by the Development Financial Institutions Act 2002 (DAFIA2002). These

[347] The general laws include the Competition Act 2010 and the Companies Act 1965.

institutions have a broader mandate of promoting development programmes in the agricultural, industrial and other commercial sectors.

Apart from the overall sector legislation, there is also specific legislation aimed at specific product offerings or functions. Capital market activities such as investment advice, capital raising and fund management activities by investment banks, for example, are governed by the Capital Markets and Services Act 2007 (see Table 5 for a full list of legislation).

Table 5: Legislation affecting the banking sector in Malaysia

Legislation	Description
Financial Services Act 2013	Provides for the regulation and supervision of financial institutions, payment systems and other relevant entities, the oversight of the money market and foreign exchange market to promote financial stability, and for related, consequential or incidental matters.
Islamic Financial Services Act 2013	Provides for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities, the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah law, and for related, consequential or incidental matters.
Anti-Money Laundering and Anti-Terrorism Financing Act 2001	This renamed and revised Act which came into force on 15 January 2002 addresses money laundering, measures taken to prevent money laundering and terrorism financing offences, and the forfeiture of terrorist property and property involved in, or derived from, money laundering and terrorism financing offences.
Money Services Business Act 2011	This Act provides for the licensing and regulation of the money-changing business, remittance services providers and wholesale currency providers.
Malaysia Deposit Insurance Corporation Act 2011	This Act addresses deposits placed with licensed commercial and Islamic banking institutions.

Source: BNM

Since the passage of both the FSA2013 and IFSA2013 in March 2013, pre-existing legislation had been repealed, including the Banking and Financial Institutions Act 1989 (BAFIA1989), the Islamic Banking Act 1983, the Payment Systems Act 2003 and the Money-Changing Act 1998. The introduction of this new legislation will have an impact on the way financial services players operate. We note that the FSA2013 imposes greater requirements on financial services providers: Boards of Directors must now demonstrate greater involvement in implementing defensive policies and programmes to ensure compliance with the FSA2013's newly imposed requirements; marketing strategies and agreements have to be re-evaluated; and more active control and supervision by BNM could be expected in the near future.

Financial Services Act 2013 (FSA2013) and Islamic Financial Services Act 2013 (IFSA2013)

These two new Acts, gazetted in May 2013, are modelled after the Basel Core Principles for Effective Banking Supervision. This higher standard of regulation is aimed at achieving a greater level of transparency, accountability and governance in the management and operation of both conventional and Islamic banking in Malaysia. The FSA2013 will also see a greater role by BNM in terms of regulating and supervising financial institutions, payment systems and other relevant activities including the oversight of the money market and foreign exchange market to promote financial stability and compliance with Islamic or Shariah law.

Specifically, the FSA 2013 and the IFSA 2013 address the issue of financial stability and provide BNM with the necessary powers to perform its regulatory and supervisory roles.[348] The new approach taken to regulate financial services reflects an early intervention approach to addressing potential issues and challenges in the sector, such as those connected to the universal banking service providers' model and the dynamic pace of financial innovations.

The new legislation also provides a more cohesive and integrated legal framework that delivers consistent and comprehensive treatment of similar risks, thus minimising the prospect of regulatory arbitrage (forum shopping) and gaps, whilst at the same time easing the process of review. Key features of the new legislation include:

- Greater transparency and accountability of BNM when undertaking enforcement activities to safeguard financial stability;
- Differentiated intensity of regulation and supervision applied to institutions and markets under BNM's purview, commensurate with the nature of activities and levels of risk posed by such institutions and markets to the overall financial system;
- Transparent assessment criteria for authorising institutions to carry out regulated financial business, and for shareholder suitability;
- New provisions for the oversight of financial holding companies and non-regulated entities to take account of systemic risks that can emerge from the interaction between regulated and unregulated institutions, activities and markets;
- Strengthened business conduct and consumer protection requirements to promote consumer confidence in the use of financial services and products; and

[348] Bank Negara Malaysia, Financial Stability and payment Systems Report 2012, Kuala Lumpur, Malaysia.

- Specific provisions to support BNM's role in the oversight of the money and foreign exchange markets in cooperation with the Securities Commission Malaysia (SC), where relevant.

Another key feature of the FSA2013 is the specific provisions addressing anti-competitive activities, which were not incorporated into BAFIA1989. For example, under Schedule 7 of FSA2013, BNM has the authority to look into specific prohibited business conduct, including collusion between players. FSA2013 also incorporates consumer protection provisions with examples of key types of business conduct that are prohibited.

4. Mechanisms to Regulate SOEs' Commercial Activities

The commercial activities undertaken by SOEs in Malaysia are subject to various regulatory mechanisms that are enforced by the both general and sector-specific regulators. As this section will highlight, the types of regulatory mechanism enforced depend on the industries in which SOEs are operating. Some SOEs are also subject to additional regulatory and reporting requirements. These regulatory mechanisms are discussed according to the order in which they were introduced.

4.1 *From the MCPC to the Investment, MOF Inc. and MOF Privatisation Division*

Efforts to regulate SOEs in Malaysia can be traced back to 1969 when the government established a Committee for the Coordination of SEDCs. The committee was tasked with supervising federal loans to the SEDCs.[349] In 1974 the government decided to establish a Ministry for the Coordination of Public Corporations (MCPC). However, other government Ministries were still responsible for some SOEs deemed to be within their area of specialisation: MAS, for instance, was under the purview of the Ministry of Transport (MOT). MCPC was renamed the Ministry of Public Enterprises (MPE) in early 1976 and was given a wider mandate which included these functions:[350]

- To monitor and coordinate corporations within its jurisdiction to ensure their policies, programmes and projects were consistent with the National Economic Policy (NEP) objectives;
- To identify and resolve problems in the operation of the corporations and in terms of inter-corporation relationships;
- To promote cooperation amongst these entities as well as with other government agencies;

[349] Gale, B. (1981), *Politics and Public Enterprise in Malaysia*, Eastern Universities Press, Singapore.
[350] *Ibid.*

- To undertake policy analyses and introduce policy changes; and
- To stimulate expansion of corporations consistent with the NEP objectives.

Both the federal SOEs and the SEDCs came under the purview of the Ministry. The MPE was later renamed the Ministry of Entrepreneur and Co-operative Development (MECD) in 2004, when it changed its mandate to promote the development of Bumiputera entrepreneurs. The MECD was disbanded after the Cabinet reshuffling in 2009 and its roles and responsibilities were absorbed into other Ministries.

Since then there has been no single Ministry in the federal government that is responsible for coordinating SOEs' activities in Malaysia. However, many view the Investment, MOF Inc. and Privatization Division in the MOF as having similar policymaking functions as the MPE by virtue of it owning the majority of federal SOEs. The Division was first established through the Establishment Warrant No. A12 Year 2000 and was later restructured through the Establishment Warrant No. A65 Year 2005. The MOF's website describes the Division's functions as including: coordinating; assessing financial positions and business plans; reviewing and formulating SOE-related policies; managing corporatisation and privatisation activities; and managing the investment and divestment of shares in MOF Inc.'s SOEs.

4.2 *Partial privatisation and the introduction of 'special rights' or 'golden shares'*

In most instances, Malaysia prefers to undertake partial and not full privatisation of its SOEs. This means that the government still holds equity shares in many of the SOEs that have undergone public listing. For instance, when MAS was first privatised in 1985, government shareholding went from 90% to 70% in the company (60% federal government; 5% Sabah government; and 5% Sarawak government). As of 31 March 2013, the government through Khazanah Nasional Berhad (KNB) directly owns 69.37% of MAS.[351] On 22 April 2011, KNB divested the government's strategic stake in the national postal service company, Pos Malaysia, totalling 32.11% to a local conglomerate, DRB-HICOM Berhad.[352]

Apart from still holding equity stakes in SOEs, the government also holds 'special shares' or 'golden shares' in some of the SOEs it considers to be operating in strategic industries and to thus have significant national interest implications. The government is mostly concerned that the newly privatised entities may not have an incentive to provide goods and services to all their consumers regardless of their geographical locations and income. For example, consumers in rural areas may no longer receive the same service that they used to enjoy when the service providers were SOEs. Again, in the case of MAS, such special shares were first

[351] See KNB's website for the latest ownership percentage.
[352] KNB (2011), 'Strategic Divestment Stake in Pos Malaysia to be Sold to DRB-HICOM', Media Statement, 22 April: http://www.khazanah.com.my/docs/Khazanah_Media%20statement_220411.pdf.

proposed and later introduced in its privatisation in 1985. The golden share in MAS provided the government with the rights to control the board of directors, priority in capital repayment in the event of the company winding up, and MAS having to redeem the special share at any time.[353]

4.3 *Establishing sector-specific regulators and enforcing sector-specific regulations*

Apart from undertaking the privatisation exercise, the government also embarked on a process of liberalisation by opening up market access to private enterprises in many sectors. This can be illustrated by the development of the Malaysian telecommunications sector.

The liberalisation of the telecommunications sector in Malaysia began in 1983 when Jabatan Telekom Malaysia (JTM, Malaysian Telecoms Department) competed with private telecommunications goods and services providers for the supply of terminal equipment such as telephones, teleprinters and radio paging services.[354] JTM was later corporatised in 1984 and privatised in 1990 to become Telekom Malaysia Berhad (TM). The telecommunications sector was further liberalised in the 1990s through the issuance of licences for mobile telecommunications operators.

In 1998, the government established a sector-specific regulator, the Malaysian Communications and Multimedia Commission (MCMC), to regulate the telecommunications sector by adopting a convergence regulation model which regulates both the communications and multimedia industries. It enforces two relevant pieces of legislation for the sector, the Communications and Multimedia Act 1998 (Act 588, CMA1998) and the Malaysian Communications and Multimedia Commission Act 1998 (Act 589, MCMCA 1998).

Since the MCMC was created, the government has also established other sector-specific regulators including the Energy Commission (EC), National Water Management Commission (SPAN) and Public Land Transport Commission (SPAD). It must be noted that the banking and finance sector as well as the capital markets are relatively more developed and so their regulators – the Bank Negara Malaysia (BNM), the Securities Commission, and Bursa Malaysia – are also comparatively more mature and sophisticated in their enforcement capacities and capabilities. Additionally, all the sector-specific regulators in Malaysia have multiple regulatory functions as they enforce both economic and technical regulations. BNM also develops and implements monetary policy while SPAD also enforces safety regulations.

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[353] Tan (2008).

[354] Jomo, K. S. and Tan Wooi Syn (2005), 'Privatization and Renationalization in Malaysia: A Survey', Expert Group Meeting on Re-inventing Public Enterprise and its Management, United Nations, available at: http://unpan1.un.org/intradoc/groups/public/documents/un/unpan021546.pdf.

These sector-specific regulators regulate the activities of all the entities under their purview, regardless of their ownership structures. In the case of TM and TNB, both the MCMC and EC set the access pricing and tariffs as both SOEs are owners of essential facilities in their respective sectors.

4.4 *Public accountability of SOEs*

Both listed and non-listed SOEs are subject to public scrutiny as the government is their shareholder. For instance, these entities are answerable to the Malaysian Parliament and they may be asked to appear before the Public Accounts Committee (PAC) in relation to any issues of public interest. The PAC, which is comprised of Members of Parliament from both the ruling and opposition parties, has been tasked with examining:

- The accounts and budgets of the federal government;
- The accounts of public authorities and other bodies administering public funds;
- Reports of the Auditor-General; and
- Other matters considered pertinent by and referred to the Committee.[355]

The Auditor General's Office also audits SOEs and the outcome of these audits are published and made public in its annual report. Meanwhile, those SOEs which received government guarantees for their fund-raising exercises are gazetted as a corporate body under the Loans Guarantee (Bodies Corporate) Act 1965 (LGA1965, Act 96). The LGA1965 authorises the government to guarantee loans raised by certain corporate bodies and restricts the borrowing powers of these entities so as they have the guarantee outstanding. In the event that default is likely, arrangements must be made to ensure that these entities can fully meet their obligations under the guarantee. With the exception of any confidential information, the line minister needs to provide all the details of the guarantee to Parliament.

Treasury Circular Letter No.11/1993 provided the policy and guidelines for dividend payments by SOEs to the government as shareholder of these entities. They are required to pay at least 10% dividend annually to the government and this percentage may be higher if the SOE recorded excess profits in a particular financial year. The dividend payment must also meet the provisions incorporated in Articles 98 to 107 of the Companies Act 1965 (MOF 1993).

[355] Parliament of Malaysia's website.

4.5 *Additional mechanisms to regulate listed SOEs*

While SOEs are government-owned, they are usually incorporated under the Companies Act 1965 (Act 125). This Act is currently enforced by the Companies Commission of Malaysia (CCM) and regulates the constitution of companies, their management and administration and their financial reporting, among other things. Thus, incorporated SOEs, like other companies, are required to file their annual financial returns to CCM; these are then accessible to the public for a small administrative fee.

Many of the larger SOEs are also listed on and regulated by Bursa Malaysia and the Securities Commission. Examples of listed SOEs are Maybank, MAS, TM and Sime Darby. As with other listed companies, these listed SOEs are subject to corporate law and notification requirements. For example, they are subject to the stock exchange requirements of publishing their annual reports and making public any information deemed pertinent to investment decisions.

In 2005, the ten-year GLC Transformation (GLCT) programme was launched to improve the performance of selected GLCs (also known as the G20[356]) based on the following three key principles:[357]

- **National development:** Growing with equity, improving total productivity and developing human capital.
- **Performance:** Creating economic and shareholder value through improved performance.
- **Governance, shareholder value and stakeholder management:** Implementation of various initiatives to engage and manage stakeholders.

The programme is overseen by the Putrajaya Committee on High Performing GLCs (PCG) chaired by the Minister of Finance. The Committee membership comprises the heads of GLICs, thus the programme can be viewed as a GLIC attempt to introduce a mechanism for self-regulation.

The GLCs have set targets for key performance indicators (KPIs), and progress reviews are undertaken annually to see whether these KPIs have been achieved. The G20 have shown significant improvements in all key financial areas since 14 May 2004. For example, their total shareholder return grew 14.5% per annum from 14 May 2004 to 13 April 2012, outperforming the rest of the listed companies in the stock exchange index by 2.4% per annum. In the same period, their market capitalisation increased from RM140 billion to RM336 billion and their

[356] There were initially 20 GLCs at the start of the programme in 2005; the number has since reduced to 17 following mergers, demergers, divestments and other corporate exercises. Of these, only UEM Group Berhad is not listed. PCG (2013).
[357] PCG (2005), 'Manual on GLC Transformation', Putrajaya Committee on GLC High Performance, Kuala Lumpur, Malaysia.

net income grew 18.2% per annum from RM9.0 billion to RM20.1 billion during the tracked period.[358]

4.6 *Enforcing generic competition law*

The Malaysian Parliament finally passed both the Competition Act 2010 (Act 712, CA2010) and the Competition Commission Act 2010 (Act 713, CCA2010) in May 2010. Both acts were subsequently given Royal assent in June 2010. The CCA2010 came into force soon after, resulting in the establishment of the Malaysia Competition Commission (MyCC) in April 2011. The CA2010 only came into force on 1 January 2012 after an 18-month moratorium.

The introduction and enforcement of these Acts marked a significant development in the Malaysian regulatory environment as they affect the conduct of market players, sector-specific regulators and policymakers in the country:

- CA2010 applies to all commercial activities[359] which have effects on competition in Malaysian markets.[360] Entities that are already subject to the Communications and Multimedia Act 1998 (CMA1998, Act 588) and the Energy Commission Act 2001 (ECA2001, Act 610) are excluded from the application of CA2010.
- CCA2010 allows for an interworking arrangement with existing sector-specific regulators on competition matters.[361]
- CCA2010 allows for the MyCC to advise policymakers on competition matters relating to government policies and other measures including legislation. In the event that they have anti-competitive effects, the Commission can make recommendations to avoid them.[362]

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[358] PGC (2012), 'GLC Transformation Programme Progress Review', Putrajaya Committee on GLC High Performance, Kuala Lumpur, Malaysia.

[359] In CA2010, 'commercial activity' means any activity of a commercial nature but does not include:

a) any activity conducted directly or indirectly in the exercise of governmental authority;
b) any activity conducted based on the principle of solidarity;
c) any purchase of goods or services not for the purposes of offering goods and services as part of an economic activity.

[360] Article 3: Application, CA2010.

[361] Article 39: Interworking with other authorities, CCA2010.

[362] Article 16: Functions of the Commission, CCA2010.

5. Conclusion: Issues and Observations

In this concluding section we analyse the existing policy and regulatory mechanisms discussed in the previous section to assess whether they adequately regulate and discipline SOEs in Malaysia.

5.1 *Partial privatisation and the introduction of 'special rights' or 'golden shares'*

The government imposes special rights or golden shares to retain control in strategic privatised SOEs so that the national interest is preserved. However, partial privatisation as well as special rights or golden shares could restrict or limit the ability of these privatised SOEs to make decisions and undertake commercial activities, thus adversely affecting their efficiency and outcomes. Additionally, they could have the unintended consequence of 'repelling' potential investors who may be keen to invest in privatised SOEs, as their decisions could potentially be overridden by the government despite these investors having majority ownership. Indeed, such shares provide the government with disproportionate controlling rights. It is most likely that these mechanisms are inconsistent with the competitive neutrality framework.

5.2 *Establishing sector-specific regulators and enforcing sector-specific regulations*

The government, as policy-maker, can direct sector-specific regulators to incorporate provisions in their regulations which address its concerns. For instance, these regulations can incorporate provisions relating to transparency, the universal service obligations (USOs), and sector-specific competition issues. Licensees must adhere to these provisions and requirements; failure to do so could see their licenses being revoked by the regulators. Examples include the CMA1998 and the Postal Services Act 2012 (PSA2012, Act 741) both of which are currently regulated by the MCMC (see Table 6 below).

The sector-specific regulations are applicable to all entities under their purview regardless of their ownership structures. In the case of the telecommunications sector, all market players have to contribute but also have access to the Universal Service Fund. MCMC also publishes sector information on its website, making it easily available to the general public. In addition, it has the power to set rates, which is crucial as SOEs may impose high rates which effectively block their competitors from accessing essential facilities or are burdensome for low-income consumers. All these together with the competition-related provisions in the regulations are consistent with the competitive neutrality framework.

Table 6: Regulatory conditions in the CMA1998 and PSA2012

Regulatory conditions	**CMA1998**	**PSA2012**
Transparency	Chapter 5: Information Gathering Powers (in Part V: Powers and Procedures of the Malaysian Communications and Multimedia Commission) – MCMC to maintain records of information which shall be made available to public and MCMC has the power to publish information.	Part XIV: Information Gathering Powers and Enforcement Provisions – provides MCMC with the power to publish information.
Rate setting	Chapter 4: Rate Regulation (in Part VIII: Consumer Protection) – provides the principles and rules of rate setting and the power of Minister to set rates.	Part VIII: Regulation of Rates – provides the principles of rate setting and how this is done.
USOs	Chapter 5: Universal Service Provision (in Part VIII: Consumer Protection) – describes the USP system and the Universal Service Fund.	Part V: Provisions Relating to the Universal Service Licensees – describes the universal service activities.
Competition	Chapter 2: General Competition Practices (in Part VI: Economic Regulation) – prohibits anti-competitive conduct and collusive arrangements and regulates dominant market players.	Part IX: General Competition Practices – prohibits anti-competitive conduct and collusive arrangements and regulates dominant market players.
Consumer protection	Part VIII: Consumer Protection – addresses quality of service and resolution for consumer disputes.	Part X: Consumer Protection – addresses how and when consumers can make complaints.
National interest	Chapter 4: National Interest Matters (in Part X: General) – this addresses the general duty of licensees, network interception capability, and special powers in an emergency.	Part XVI: National Interest Matters – this addresses the general duty of licensees, interworking with other authorities, and special powers in emergency.

Source: MCMC's website

5.3 *Public accountability of SOEs*

The PAC has directed some SOEs to provide details of their transactions or projects that are of public interest. For example, Khazanah Nasional Berhad has appeared before the Committee (KNB, 2013). The Committee also issues comments on any such transactions as it sees fit. Indeed, on 10 September 2013, the PAC issued a statement reminding SOEs, including Khazanah Nasional Berhad, to adhere to the best practices of corporate governance in light of the RM10 million fine imposed by the Malaysia Competition Commission (MyCC) on MAS for the Air Asia-MAS share swap deal in 2012.[363]

Meanwhile, in the 2012 Auditor General Report, there were comments and observations on the financial performance of some SOEs such as RapidKL, UDA Holdings Bhd, Malaysia International Franchise Sdn Bhd and Indah Water Konsortium Sdn Bhd (IWK). The national sewerage company, IWK, was observed to be 'too dependent on government subsidies to cover rising operating expenses'. As of end-2010, its accumulated losses came to approximately RM889 million.[364]

As regards government guarantees, JCorp received government guarantees from both the federal and state governments for their issuance of RM3 billion in Islamic bonds in 2012. As such it was gazetted as a corporate body under the LGA1965 on 7 May 2012.[365] Meanwhile, the sub-section on the fiscal implications of SOEs highlights that dividend payments were made by some SOEs to the government.

While these examples highlight how some of SOEs may benefit from their transactions and take advantage of their relationship with the government, they also highlight the efforts made by the government to be transparent in its relationship with such entities, as well as to ensure they are accountable for their financial activities.

5.4 *Additional mechanisms to regulate listed SOEs*

Bursa Malaysia and the SC emphasise information transparency as a way to reduce information asymmetry problems: investors require as much relevant information on stocks as possible for them to make informed investment decisions. Information about companies, including listed SOE, is easily accessible and available through a diverse range of platforms such as the regulators' websites, SOEs' websites, business channels such as Bloomberg and daily newspapers.

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[363] NST (2013), 'Reminder to GLCs to observe best practices', *The New Straits Times online*, 10 September: http://www.nst.com.my/general/reminder-to-glcs-to-observe-best-practices-1.52814.
[364] NST (2012).
[365] Jcorp (2012), ' Johor Corporation Annual Report', Johor Corporation, Johor, Malaysia.

However, as with other non-listed companies, non-listed SOEs are not required to publish their annual reports, although some do to signal their confidence in their operations and financial outcomes. In Malaysia, information for non-listed SOEs can be retrieved from the CCM but is not available online.

Meanwhile the GLCT programme provides the G20 with best practice recommendations which cover a diverse range of business management and administration issues, including corporate governance, appointment of directors, separation of commercial and non-commercial activities, and procurement policies and practices. These are benchmarked against practices in the best performing international companies.

The earlier transparency requirements were only partially consistent with the competitive neutrality framework. The GLCT programme is more consistent with the competitive neutrality framework as it promotes and develops competitive SOEs by setting performance targets for their CEOs. It also encourages transparency as both the targeted and actual KPIs are published thus allowing for SOEs' performances to be tracked by the public.

5.5 *Enforcing generic competition law*

The CA2010 focuses on activities, thus all market players are regulated regardless of their ownership structure (state or non-state), nationality (domestic or foreign) and size (dominant or small and medium enterprises, SMEs). Furthermore, unlike some generic competition laws in other jurisdictions, the CA2010 has short exemption and exclusion lists, thus providing as wide a coverage over the markets as possible. Already MyCC has shown its willingness to investigate SOE-related competition cases such as the Air Asia-MAS share swap deal in 2012[366]and as mentioned earlier, it has imposed fines on these two companies.[367] This is positive as it addresses issues similar to the competitive neutrality framework.

5.6 *Conclusion*

Malaysia does not have an explicit competitive neutrality framework in its regulatory environment. It is unclear that the current fiscal and regulatory mechanisms address all the issues of net potential advantages that are of concern in the competitive neutrality framework. However, from the discussion above, it can be seen that they do partially meet the competitive neutrality framework as they provide greater transparency and accountability as well as setting performance targets to be achieved by SOEs.

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[366] Sidhu, B. K. (2012), 'MYCC to investigate if AirAsia-MAS share swap has made airfares go up', *The Star online*, 4 January: http://biz.thestar.com.my/news/story.asp?file=/2012/1/4/business/10199177&sec=business.

[367] Air Asia is a non-SOE. Both Air Asia and MAS had since decided to terminate the share swap deal.

The competitive neutrality framework as developed and implemented in developed countries such as Australia may not be suitable given the current economic development and conditions in Malaysia, but the development and evolution of the regulatory environment so far highlights the possibility that the government may gradually move towards adopting such a framework when conditions permit. Indeed, the government may want to consider phasing out policy mechanisms which may not be consistent with the competitive neutrality framework and to continue to refine, develop and enforce the identified regulatory mechanisms which have the same effects and outcomes as the competitive neutrality principles. We are happy to note that some sector-specific regulators such as the BNM are working towards amending their sector-specific regulations to be consistent with the application of the CA2010 and CCA2010. The challenge for the government is to find the right balance between promoting competitive and efficient markets, and managing political sensitivities.

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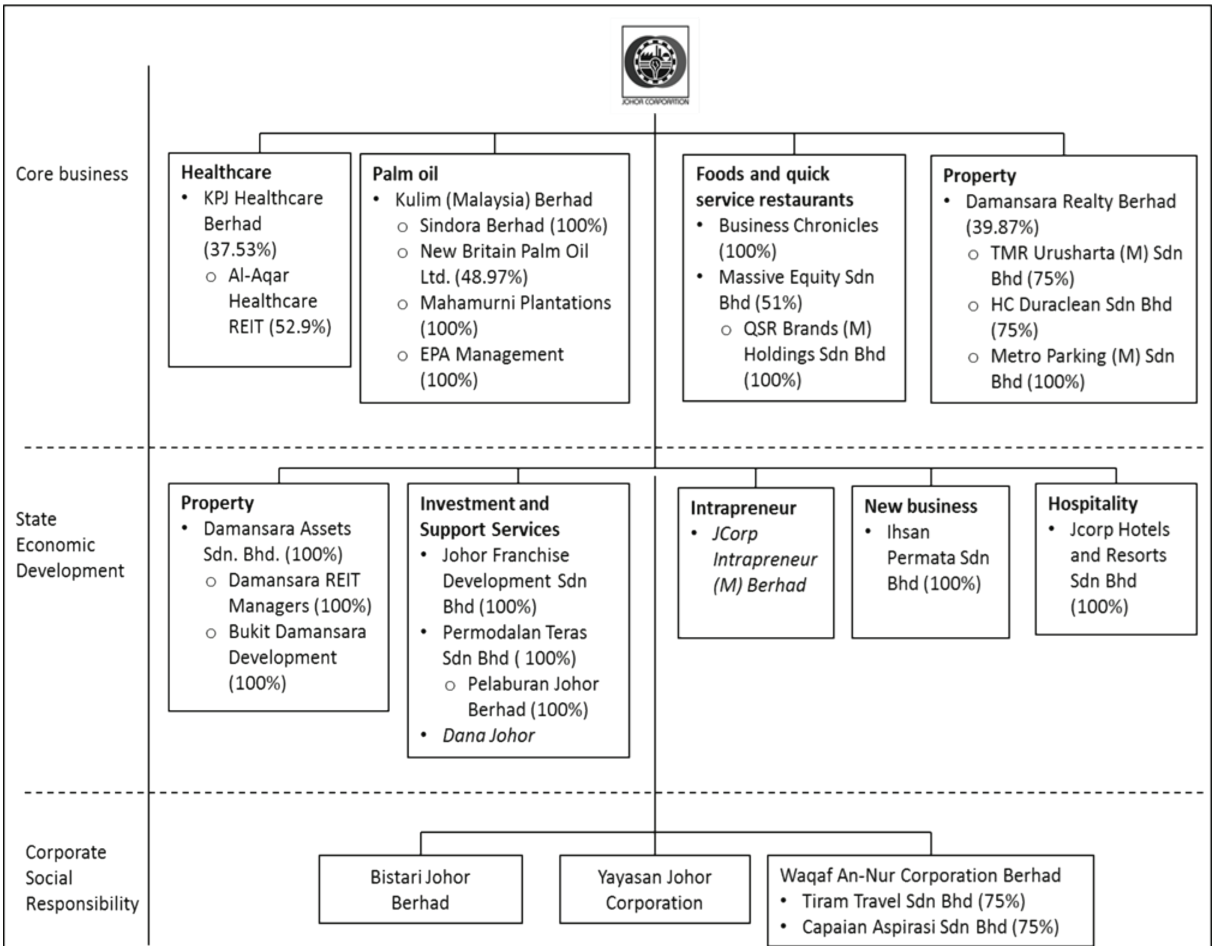
Telekom Malaysia Berhad: www.tm.com.my

TH Plantations: www.thplantations.com

Appendices

Diagram A1: Johor Corporation Corporate Structure (as of 2012)



Note: *Companies/organisations in italics denote management by JCorp, but not direct ownership*

Source: Authors (adapted from JCorp (2012)).

Table A1: List of banking institutions in Malaysia (as of June 2013)

	Commercial Banks		Islamic Banks		Investment Banks
1	Affin Bank Berhad	1	Affin Islamic Bank Berhad	1	Affin Investment Bank Berhad
2	Alliance Bank Malaysia Berhad	2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	2	Alliance Investment Bank Berhad
3	AmBank (M) Berhad	3	Alliance Islamic Bank Berhad	3	AmInvestment Bank Berhad
4	Bangkok Bank Berhad	4	AmIslamic Bank Berhad	4	CIMB Investment Bank Berhad
5	Bank of America Malaysia Berhad	5	Asian Finance Bank Berhad	5	ECM Libra Investment Bank Berhad
6	Bank of China (Malaysia) Berhad	6	Bank Islam Malaysia Berhad	6	Hong Leong Investment Bank Berhad
7	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad	7	Bank Muamalat Malaysia Berhad	7	Hwang-DBS Investment Bank Berhad
8	BNP Paribas Malaysia Berhad	8	CIMB Islamic Bank Berhad	8	KAF Investment Bank Berhad
9	CIMB Bank Berhad	9	Hong Leong Islamic Bank Berhad	9	Kenanga Investment Bank Berhad
10	Citibank Berhad	10	HSBC Amanah Malaysia Berhad	10	Maybank Investment Bank Berhad
11	Deutsche Bank (Malaysia) Berhad	11	Kuwait Finance House (Malaysia) Berhad	11	MIDF Amanah Investment Bank Berhad
12	Hong Leong Bank Berhad	12	Maybank Islamic Berhad	12	MIMB Investment Bank Berhad
13	HSBC Bank Malaysia Berhad	13	OCBC Al-Amin Bank Berhad	13	OSK Investment Bank Berhad
14	Industrial and Commercial Bank of China (Malaysia) Berhad	14	Public Islamic Bank Berhad	14	Public Investment Bank Berhad
15	J.P. Morgan Chase Bank Berhad	15	RHB ISLAMIC Bank Berhad	15	RHB Investment Bank Berhad
16	Malayan Banking Berhad	16	Standard Chartered Saadiq Berhad		
17	OCBC Bank (Malaysia) Berhad	17	Alkhair International Islamic Bank Berhad		
18	Public Bank Berhad	18	Deutsche Bank Aktiengesellscahft		
19	RHB Bank Berhad	19	Elaf Bank B.S.S		
20	Standard Chartered Bank Malaysia Berhad	20	PR. Bank Syarish Muamalat Indonesia, Tbk		
21	Sumitomo Mitsui Banking Corporation Malaysia Berhad				
22	The Bank of Nova Scotia Berhad				
23	The Royal Bank of Scotland Berhad				
24	United Overseas Bank (Malaysia) Berhad				
25	India International Bank (Malaysia) Berhad				
26	Mizuho Corporate Bank (Malaysia) Berhad				
27	National Bank of Abu Dhabi Malaysian Berhad				

Source: BNM

Table A2: GLICs with shareholdings in Malaysian banking institutions

GLICs	Overview	Objectives	Banking institution
Employees Provident Fund	Social security institution established in 1991.	• To provide retirement benefits for members through management of their savings. • To provide a framework for employers to meet their statutory and moral obligation to their employees.	RHB Capital
Khazanah Nasional Berhad	Investment holding arm and strategic investor incorporated in 1993.	• To hold and manage the investments entrusted to it by the Government of Malaysia. • To undertake new investments where there are strategic opportunities, in new sectors and markets.	CIMB Bank Bank Muamalat
Lembaga Tabung Haji (Pilgrims Fund Board)	Administrator of funds associated with the welfare of Hajj pilgrims established in 1973.	• To provide hajj management services to Muslim Malaysians.	Bank Islam Malaysia Berhad
Lembaga Tabung Angkatan Tentera (Armed Forces Fund Board)	Superannuation scheme for members of the Armed Forces established in 1972.	• To enable officers and mobilised members of the volunteer forces in the service to participate in a savings scheme. • To provide retirement benefits to members of the Armed Forces and volunteers.	Affin Holdings
Permodalan Nasional Berhad	Fund management company and pivotal instrument of the Government's New Economic Policy, incorporated in 1978.	• To promote share ownership in the corporate sector among the Bumiputera[368] community. • To develop opportunities for suitable Bumiputera professionals to participate in the creation and management of wealth.	Malayan Banking Berhad (Maybank)

Source: Author (from various websites)

[368] For Peninsular Malaysia, Bumiputera is defined as 'Malay' or 'aborigine' under Article 160(2) of the Federal Constitution. For Sarawak and Sabah, Bumiputera is define as 'native' of Sarawak or Sabah under Article 161(A) Clauses (6a), (6b) and (7) of the Federal Constitution.

Competitive Neutrality in Malaysia's Telecommunications Industry

May Fong Cheong* and Pushpa Nair**

1. Introduction

This chapter examines whether and to what extent principles of competitive neutrality (CN) apply in Malaysia, specifically in relation to the telecommunications industry. The incumbent, Telekom Malaysia Berhad (TM), which originated as a public utility in the hands of the state, is among the principal players. As a state-owned enterprise (SOE), TM's legal nature has evolved through corporatisation, privatisation and it is now a government-linked company (GLC). The telecommunications industry also represents a vital economic activity and the government has played, and continues to play, an important role in the industry.[369] The government's former role as owner, operator and regulator, its current presence through the regulator, the Malaysian Communications and Multimedia Commission (MCMC), and as an interested stakeholder and player in several GLCs in the telecommunications sector that compete with other private enterprises, all raise CN issues. The telecommunications industry is also particularly significant as the Communications and Multimedia Act 1998 (CMA) was the first Malaysian legislation providing for a competition law framework.

It is acknowledged that 'competition alone is not sufficient in ensuring a level playing field for SOEs and private enterprises';[370] however competition law provides the threshold measure to ensure a competitive environment. Competition law provides an *ex post* remedy,[371] but it is a remedial option where government business falls within its scope. The legal application

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[369] For a fuller account of the history, early developments and changes to the industry, see Cheong, May Fong (2011), 'State Relations in the Telecommunications Industry in Malaysia' *Macquarie Journal of Business Law* 8, pp. 279-299.

[370] OECD Policy Roundtables on State Owned Enterprises and the Principle of Competitive Neutrality, 2009. Available at: http://www.oecd.org/daf/competition/prosecutionandlawenforcement/46734249.pdf.

[371] A serious limitation is that this remedy is effected by requiring businesses to cease actions that have a detrimental impact on competition, while an *ex ante* approach allows for policies to change governance arrangements to reduce the advantages that government business enjoy, through e.g. corporate governance and procurement policy. See Capobianco, Antonio and Hans Christiansen (2011), 'Competitive Neutrality and State-Owned Enterprises – Challenges and Policy Options' (OECD Corporate Governance Working Paper No 1, OECD Publishing, p. 11).

of competition law has been identified as one of three key barriers to CN.[372] The CMA, as Malaysia's first competition law provisions, and the MCMC, with close to 15 years' experience dealing with these provisions, makes an examination of the telecommunications industry an apt subject for this chapter, in which the application of competition law provisions in the CMA forms the key discussion.

Following this Introduction, Section 2 considers the concept of CN and identifies the competitive advantages enjoyed by SOEs and the barriers to CN, whilst also briefly introducing SOEs and GLCs in the Malaysian context.

Section 3 forms the core of the chapter and examines the role of competition law in enhancing CN in the telecommunications industry in Malaysia. Following an overview of the development of the Malaysian telecommunications industry, the chapter will consider two issues: firstly, whether and to what extent CN considerations have been given explicit or implicit legislative recognition in the CMA, and secondly, how these considerations have been applied in practice by setting out three case studies. Through this process we observe how the provisions of the CMA impact on CN by considering the legislative intent of the statutory provisions, the application of these provisions by MCMC and where relevant, by the relevant Minister under specific provisions in the CMA.

Section 4 adopts a broader approach and sets out some policy tools and developments in the Malaysian commercial landscape that may impact on CN principles. Following the high-level report by the National Economic Advisory Council (NEAC)[373] on 31 August 2010 that raised concerns about the government's conflicting roles and recommended separating its roles as regulator, operator and market player, concerted measures have been taken. While not explicitly expressed as a response to CN concerns, some of these developments may be seen as an *ex ante* approach, along with corporate governance and public procurement and other policies that can enhance CN. This is followed by concluding observations in Section 5.

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[372] United Kingdom Office of Fair Trading (OFT) (2010), 'Competition in Mixed Markets: Ensuring Competitive Neutrality', p. 19: available at http://www.oft.gov.uk/shared_oft/economic_research/oft1242.pdf. The other two barriers are: i) differences in regulation, pension, and tax treatment between public private and third sector providers; and ii) incumbency advantages enjoyed by existing firms, such as access to information, pre-qualification and bid criteria, and transition costs.

[373] The National Economic Advisory Council (NEAC) was inaugurated by the Prime Minister on May 2009 with a specific mandate to formulate a New Economic Model (NEM) that will drive Malaysia's transformation into an advanced nation by 2020. The NEAC comprising top officials from both the public and private sector completed its mandate officially on 31 May 2011 and submitted its recommendations after extensive discussions with stakeholders, ranging from business leaders and government officials to civil society groups and academia. These recommendations have been summarised into the NEM Concluding Part Report. The papers by NEAC are available at: http://www.neac.gov.my. This website also states that the implementation of the policy measures as recommended by the NEAC is now being undertaken by the relevant government agencies under the coordination of the Performance Management and Delivery Unit (PEMANDU), Prime Minister's Department.

2. Competitive Neutrality

A helpful starting point on CN is the Australian Commonwealth Competitive Neutrality Policy Statement which states, among other things that '[c]ompetitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership.' Australia is one of the few countries with an established CN framework that is viewed as 'highly successful overall'[374] and its Competitive Neutrality Policy Statement has been referred to by the OECD and by the United Kingdom's Office of Fair Trading. The OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOE Guidelines)[375] state that '[t]he legal and regulatory framework for state-owned enterprises should ensure *a level playing field* in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions'. It further recommends that CN frameworks be 'developed with a view to its impact on overall economic performance, market integrity and the incentives it creates'. This has been interpreted to mean that 'whereas governments are free to set rules and objectives for their SOEs consistent with overall political priorities, an ultimate goal should be to enhance economic performance and market integrity'.[376]

The previous statement is important for a contextual understanding of the commercial landscape, including in Malaysia. In the context of structural reform in Malaysia, privatisation may involve bodies or entities where the government holds the majority of shares. In this respect, it is pertinent that the OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets recognised different choices a government faces in this process. Its Best Practice Report states that it applied 'a relatively encompassing approach: *As privatisation may be considered any material transaction by which the state's ultimate ownership of corporate entities is reduced*'.[377]

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[374] Rennie, Matthew and Fiona Lindsay (2011), 'Competitive Neutrality and State-Owned Enterprises in Australia: Review of Practices and their Relevance for Other Countries', *OECD Corporate Governance Working Papers*, No. 4, OECD Publishing, available at: http://www.oecd-ilibrary.org/governance/competitive-neutrality-and-state-owned-enterprises-in-australia_5kg54cxkmx36-en. It is useful from the start to highlight the factors behind Australia's apparent success, identified by the authors as follows: a reform program that applied both to SOEs and to specific industries; the flexibility to apply the framework differently in different geographic contexts; anchoring the commitment to competitive neutrality in strong administrative processes; regular reviews and reporting by individual jurisdictions on the progress of their reforms; clarity in communication to enhance a nationwide understanding of the goals and mechanisms to achieve those goals; transparent public benefit tests to establish the boundaries between commercial and non-commercial public activities; and transparent and politically independent review processes.

[375] OECD (2005), p. 12, available at: http://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf.

[376] Capobianco and Christiansen (2011), p. 5.

[377] OECD (2010), 'Privatisation in the 21st Century: Summary of Recent Experiences', available at: file://infpwfs101.ad.unsw.edu.au/Staff002$/z3310483/COMPETITION/COMPETITIVE%20NEUTRALITY%20PROJECT/OECD%20Mat/privatisation%20in%2021st%20century%202010.pdf.

In order to assess whether and to what extent CN principles apply in the telecommunications industry in Malaysia, it is necessary to identify the advantages enjoyed by SOEs that create barriers to a CN environment.[378] Locating the source of the problem is important as it will point to the appropriate tool to remedy the matter. As noted by Capobianco and Christiansen, if competitive distortions arise from a deliberate decision by a government to favour its businesses, then 'advocacy' may be the most effective approach. On the other hand, if these distortions arose from the unintended consequences of other government policies, then transparency rules and specific CN policies may be more effective.[379] The same authors have identified six basic advantages enjoyed by SOEs as follows:

1. **Outright subsidisation**: these direct subsidies can come in the form of financial assistance to sustain SOEs' commercial operations, such as favourable tax regimes by way of exemptions from certain taxes, benefits in kind such as land usage or rights of way at prices significantly lower than those that private firms have to pay in like circumstances.

2. **Concessionary financing and guarantees**: these are enjoyed either directly through credits received at below market interest rates or through state guarantees; the latter may be implicit by virtue of their government connection thus reducing their cost of borrowing or enhancing their competiveness vis-à-vis private borrowers.

3. **Other preferential treatment by government**: this can come in the form of exemptions from costly regulatory regimes such as disclosure requirements or antitrust regulations. It can also be positive in the mode of informational advantage by virtue of SOEs having access to government information enabling them to better tailor their offers in government procurement exercises.

4. **Monopolies and advantages of incumbency**: these arise from exclusive or monopoly rights over some commercial activities, often by way of historical legacies from being the initial state provider of certain public utilities, which continues to impact on competitiveness by influencing the entry conditions of new and younger competitors.

5. **Captive equity**: this relates to a situation where SOE equity is 'locked in' as control of an SOE cannot be transferred easily, resulting in advantages including being absolved from paying dividends to shareholders or management being less incentivised to operate the company efficiently.

6. **Exemption from bankruptcy rules**: besides being a given advantage, this is also related to captive equity; because equity capital is locked in, SOEs can risk generating losses for a long time without the fear of going bankrupt.

[378] UK OFT (2010), 'Competition in Mixed Markets', p. 19.
[379] Capobianco and Christiansen (2011), p. 11.

As outlined in the following section, some of these advantages are present within the telecommunications industry in Malaysia, in particular the advantage of incumbency enjoyed by TM. Commentaries on CN also highlight that SOEs may also suffer disadvantages[380] by virtue of their status and have also noted the difficulties of determining net advantage or disadvantage.[381]

SOEs have been defined by the World Bank as 'government-owned or government-controlled economic entities that generate the bulk of their revenues from selling goods or services'.[382] SOEs under this general definition exist in Malaysia at the federal and state government level. A more common terminology especially within the telecommunications industry is GLC, which has been given different definitions by different bodies making it difficult to collect data and analyse their progress and impact. Three definitions are currently available:[383] i) the Putrajaya Committee on GLC Transformation (PCG); ii) Bank Negara Malaysia (BNM, the Central Bank); and iii) the definition by the National Economic Advisory Council (NEAC), the latter being the broadest.

The Putrajaya Committee on GLC Transformation (PCG)[384]

GLCs are defined as companies in which the Malaysian government has a controlling stake, while GLICs are Federal Government-linked entities that invest in GLCs. This definition omits companies owned by state governments.

Bank Negara Malaysia (BNM, the Central Bank)

The Central Bank uses the terminology Non-Financial Public Enterprises which encompass:

- Government-owned business entities involved in the sale of goods and commercial services or manufacturing, and
- those which have at least 51% of their equity owned by the government, record at least RM100 million in sales turnover, and have a significant impact on the Malaysian economy.

By virtue of the high figures set, this definition omits many companies where the government has interests but are excluded from the definition either because the equity of the government is less than 51% or sales turnover is less than RM100 million.

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380 These include greater accountability obligations; requirements to provide various community services; reduced managerial autonomy; requirements to comply with government wages, employment and industrial relations policies; and higher superannuation costs. See Australian Government Publishing Service (1993), 'National Competition Policy', p. 13, available at: http://www.australiancompetitionlaw.org/reports/1993hilmer.html.

381 UK OFT (2010), 'Competition in Mixed Markets', p. 19.

382 World Bank (1995), 'Bureaucrats in Business: The Economics and Politics of Government Ownership'.

383 NEAC Report.

384 The PCG was formed in January 2005 to implement the GLC Transformation Programme which was launched by the Government in May 2004 to drive development and grow the economy, with inter alia, a key focus on enhancing performance of GLCs. See the PCG website at: http://pcg.gov.my/about_us_overview.asp.

National Economic Advisory Council (NEAC)

The NEAC defines GLC as a company:

- having a distinct legal entity, operating in commercial affairs,
- which can be controlled by the federal or state government (directly via shareholdings or indirectly via interposing holding companies), and
- is directly funded by the government or exposes it to contingent liabilities via capital, debt or income guarantees.

The essence of GLCs is that they are companies with a primary commercial objective in which the government has a controlling stake. Controlling stake in this context refers to the ability of the government to appoint board members and senior management, and make major decisions for the GLC in question.[385] The number of GLCs is substantial and their growing impact on the Malaysian commercial landscape has become a matter of concern, raising *inter alia* the issue of whether they are crowding out private investment.[386] These issues will be considered in Section 4 following an examination of the key issues of CN in the telecommunications industry.

3. The Telecommunications Industry in Malaysia

This section forms the core discussion of this chapter and comprises four parts: firstly, an introduction to the telecommunications landscape commencing from its early history to the present day; secondly, the competition provisions in the CMA; thirdly, the application of the competition provisions through three case studies; and finally, some policy tools and measures which impact on CN in Malaysia. Observations on the existence and extent of CN principles in the telecommunications industry will be made in the second and third parts.

3.1 *Historical background*

Telecommunications in Malaysia were originally operated by a state entity due largely to the country's public utility element, and within this framework, the state played a tripartite role as owner, operator and regulator. In 1946, Jabatan Telekom Malaysia (JTM), a government department under the Ministry of Energy, Telecommunications and Posts, was established. However like other public utilities charged with the provision of essential services, the inefficiency of JTM as an SOE, compounded with changing market structures and technologies in the industry, led to the need for reform. The telecommunications landscape started to

[385] Khazanah Nasional Berhad, 'Frequently Asked Questions', available at: http://www.khazanah.com.my/faq.htm.

[386] Menon, Jayant and Thiam Hee Ng (2013), 'Are Government-Linked Corporations Crowding out Private Investment in Malaysia', Working Paper in Trade and Development, available at: http://www.apeaweb.org/confer/osaka13/papers/Ng_Thiam.pdf.

undergo significant changes with the decision to corporatise, then privatise and list the government department of telecommunications in the 1980s.[387] These measures were in line with the country's liberalisation and privatisation[388] of SOEs and the Malaysia Incorporated[389] concept aimed at achieving Malaysia's Vision 2020 plan and becoming a fully developed and industrialised nation by the year 2020.[390]

Competition was introduced in the market by issuing new licences for fixed line, mobile and internet services in the early 1990s.[391] During this time, the government was very engaged in attracting foreign investment, in particular from digital technology companies, and several strategies were undertaken in this vein. These included the establishment of the Multimedia Super Corridor and the introduction of new legislation that dealt with a converged technological landscape, that is, the convergence of telecommunications, broadcasting and the internet. Thus, the CMA was enacted to deal with the convergence phenomenon.

The current regulatory framework was put in place in 1999 with the coming into force of the CMA on 1 April 1999. This was trailblazing legislation in the Malaysian context as it not only covered a convergence perspective but also best practice concepts, such as transparency and stakeholder consultation, as part of the regulatory process. The new scheme brought telecommunications and broadcasting under one legislative framework, and also covered the internet. A new regulator, the Malaysian Communications and Multimedia Commission (MCMC), was established as an entity separate from the various ministries involved, having its own commissioners, staff and funding.[392]

The new legislation and the establishment of the MCMC required initiatives to deal with both existing and historical matters, such as existing licences and regulations, as well as future matters, for example, new licences and new regulations. The first priority was to bring all those directly affected under the new regime. This entailed a two-step process: the migration of licensees under the old Telecommunications Act 1950 and the Broadcasting Act 1988 to licences under the new regime; and the registration and processing of new licence

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[387] The relevant legislation included the Telecommunications Act 1950 and the Telecommunication (Successor Company) Act 1985.

[388] See Government Printers (1991), 'Privatisation Masterplan for Malaysia', also available at: http://www.epu.jpm.my. In relation to the telecommunications industry, see also bin Isahak, Daud, 'Meeting the challenges of privatisation in Malaysia', *Restructuring and Managing the Telecommunications Sector*, B. Wellenius et al (eds), pp. 118-21, World Bank, Washington DC.

[389] See LimKokWing Sdn Bhd (1995), *Malaysia Incorporated*, Kuala Lumpur.

[390] The blueprint for this vision was delivered by the former Prime Minister, Tun Dr Mahathir Mohamed, to the *Dewan Rakyat* (Lower House) on 17 June 1991. See Ahmad Sarji Abdul Hamd, Chief Secretary to the Government of Malaysia (ed) (1993), *Malaysia's Vision 2020: Understanding the Concept, Implications and Challenges* (Selangor: Pelanduk Publications).

[391] See Lee, C. (2002), 'Telecommunications Reforms in Malaysia', *Annals of Public and Cooperative Economics* 73:4, pp. 521-540; see also Painter, Martin and Shiu-fai Wong (2005), 'Varieties of the Regulatory State? Government – Business Relations and Telecommunications Reforms in Malaysia and Thailand', *Politics and Society* 24:3, pp. 27-52.

[392] See Communications and Multimedia Commission Act 1998.

applications. The existing regulations, rules and requirements were updated and translated to the form and requirements of the CMA, and intensive information and education on the new regime was provided to the public and all stakeholders.

The licences of existing industry players were analysed, mapped onto the new framework and categorised into appropriate class and individual licensees. The current major telecom companies for both fixed line and mobile were already operating and included Telekom Malaysia Berhad (TM), Celcom Axiata Berhad (Celcom), Time dotCom Berhad (Time), Maxis Berhad (Maxis) and DiGi Dotcom Berhad (DiGi). The first three companies are all considered GLCs, as they have the government investment arm Khazanah Nasional Berhad (Khazanah) as a substantial shareholder. The last two companies are major private investors; DiGi is majority owned by Telenor of Norway.

All of these companies are incorporated under the Malaysian Companies Act 1965 and are licensed under the CMA. Government influence, if any, is exercised through the shareholding of Khazanah. There is no exemption from the application of the CMA for these licensees.

Corporatisation and privatisation of JTM has partly addressed a major concern of CN – the competitive advantages enjoyed by JTM by virtue of government ownership. The process of privatisation entails the transfer of ownership from government business to the private sector. Corporatisation aims at converting a public enterprise into a firm; both processes contribute to reducing the advantages that may be enjoyed by GLCs. However, in addition to the advantage of incumbency, TM may continue to enjoy competitive advantages through its access to government. The following considers the workings of the industry through an evaluation of the competition provisions in the CMA.

3.2 *Economic regulation in the CMA*

The legislative framework of the CMA provides four main areas of regulation comprising: i) economic regulation that covers licensing, competition and access; ii) technical regulation which covers spectrum and numbers; iii) consumer protection which covers consumer protection, universal service and rate regulation; and iv) social regulation which covers matters relating to content. Of the four, the regulatory area that impacts most on CN is economic regulation; thus the three sub-areas of licensing, competition and access will be considered in detail. This will be followed by a consideration of technical regulation, consumer protection and social regulation.

3.2.1 Licensing

The new convergence regime in the CMA introduced two concepts of licensing: firstly, licensing based on activity, and secondly, individual and class licences.

Licensing based on activity

All GLCs had licences under the old regime and they were migrated to the new regime with the new licences. The same method and principles were applied to all licensees. A series of meetings was held with each migrating licensee and drafts of the actual licences were discussed with them before the documents were finalised.

However the licensing scheme itself was a total departure from traditional telecommunications licensing, which stipulates the nature of the service, for example, PSTN or cellular mobile service. This usually meant that different licences were required for different activities, even if carried out on the same platform.

The CMA sought to address the effects of convergence where the same platform could support a variety of applications such as mobile and internet access, and introduced a technology neutral licensing framework. Licensable activities fall into several broad categories, namely: network facilities, network services, applications services and its subset of content applications services. The scope of these activities is explained in the Explanatory Statement to the Communications and Multimedia Bill as follows:[393]

Network facilities providers (NFP)

Owners of facilities such as satellite earth stations, broadband fibre optic cables, telecommunications lines and exchanges, radio communications transmission equipment, mobile communications base stations and broadcasting transmission towers and equipment.

Network service providers (NSP)

Provide basic connectivity and bandwidth to support a variety of applications.

Applications Service Providers (ASP)

Provide particular functions such as voice services; data services, content based services, electronic commerce and other transmission services.

Content Applications Services (CASP)

Subset of ASPs including traditional broadcast services and newer services, such as online publishing and information services.

Applicants apply separately for each of these four licences. Thus if a licensee wishes to provide voice or internet access but does not wish to roll out an extensive network, they can lease the network from those licensed for network facilities and network services but are themselves only required to have a licence for applications services.

[393] See Explanatory Statement to the Communications and Multimedia Bill, para 7.

The only express exemption from licensing is for a precise and limited group namely:

- the Yang dipertuan Agung and the state authority in respect of their official residence; and
- the federal government and all federal departments.

Thus, in terms of CN, no difference is envisaged in regards to GLCs and licensing.

The scope of licensable activities was therefore widened so as not to require separate licences for each type of activity covered under that category. In other words, if the licensee chooses to provide voice services they can do so under an ASP licence, yet if they subsequently choose to provide internet access they can do so without needing an additional licence, as this is already covered by the scope of applications services. If however they subsequently choose to establish their own networks, they can apply for the relevant NFP and NSP licences. Thus each market participant can choose to enter the market at a level feasible for them. As a result, competition is encouraged by allowing easier entry and exit of market participants.

Individual and class licences

The CMA also introduced the concept of individual and class licences. The former was introduced for activities that, among other things, affect a large section of the community or where the significance of the service is such that close regulatory supervision is required. Individual licences require an application and are processed by the MCMC, with a recommendation made to the Minister for approval. The MCMC processes all applications but the Minister is the licensing authority and has sole decision-making power on the granting of licences. This situation raises the question of CN in the context of the possible influence of the government in the decision-making process.

In contrast, class licences require an annual registration, which is intended to facilitate market entry, encourage innovation and promote healthy competition. In the case of a class licence, instead of an application procedure, the Minister issues a licence for a certain activity or group of activities. Parties who wish to conduct activities under class licences merely register annually. This was the first introduction of such light-handed licensing in the telecommunications sector.

The CMA requires that licenses are listed on a publicly available register, including an electronic register. This means that any discrepancies, such as additional rights included in GLCs' licences, will be manifest to all. To this extent, the CMA has introduced transparency principles that are important for CN in the licensing process. However, it is interesting to note that while the register for earlier licenses set out the complete licence, the current register does not do so.

Further, despite the Communications and Multimedia (Licensing) Regulations 2002 stipulating that all individual licences are valid for a period of ten years,[394] it seems that the Minister has in fact renewed some licences, including those of one GLC (Celcom), for only five years. This is clearly contradictory to the statutory provision and may not be competitively neutral. However, there have been changes to the Cabinet in relation to ministerial portfolios arising from the May 2013 elections and a new Minister and Deputy Minister in charge of the Communications and Multimedia Ministry have been appointed. Thus we await future developments to see if these matters are corrected and whether new licences are granted or renewed in accordance with statutory requirements.

When the licences under the old regime were migrated to licences under the CMA, no additional licence fees were charged as all existing licence holders had already applied and paid the relevant fees. All of the licensees at that time, whether GLC or otherwise, were treated equally and licence conditions did not differ on the basis of the GLC status or otherwise of the holder.

3.2.2 Competition

The CMA was the first legislation to introduce competition law principles in Malaysia. Under Part IV Chapter 2 of the CMA, the two fundamental prohibitions of anti-competitive agreements and abuse of dominance are enshrined. These provisions allow for guidelines to be issued in instances of substantial lessening of competition and abuse of dominance. In addition, several types of conduct have been made *per se* breaches regardless of economic effect.

Before going into the details of these competition provisions in the CMA, it should be noted that a comprehensive national competition regime was introduced via the Competition Act 2010, which took effect on 1 January 2012.[395] This regime deals with general competition law in Malaysia. The communications and multimedia sector and the energy sector are exempted from its application, presumably on the basis that these sectors are already subject to specific competition provisions.[396] This process risks the development of different views and approaches between the different regulators. To overcome this, the Malaysia Competition Commission (MyCC) has established a committee known as the Special Committee on Competition, with members from all relevant regulatory authorities. This committee will meet regularly and discuss and streamline the approach taken so as to minimise inconsistencies.

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[394] See Communications and Multimedia (Licensing) Regulations (2002), reg. 11(1).

[395] Cheong, May Fong (2011), 'A New Catalyst for Malaysia: The Competition Act 2010', *The Law Review* pp. 107-123.

[396] For the telecommunications sector, this is clear from the extensive provisions on competition in the CMA. However, for the energy sector, section 14(h) of the Energy Commission Act 2001 is the only provision making reference to competition.

MyCC has issued guidelines on market definition, Chapter 1 prohibition, Chapter 2 prohibition, and the complaints procedure.[397] While having a similar objective and covering the same essential principles (prohibiting anti-competitive agreements and abuse of dominance), the terminology used differs from that of the CMA.

The following section examines the two sets of guidelines issued under the CMA.

Guidelines on substantial lessening of competition

Section 133 of the CMA contains the fundamental provision against anti-competitive activity and states that a licensee shall not engage in any conduct that has the purpose of substantially lessening competition in a communications market. In this case prohibition is based on the intention or purpose behind the activity concerned.

Section 134 of the CMA provides for guidelines to be issued on the meaning of substantial lessening of competition[398] and include the following matters:

a) the relevant economic market;
b) global trends in the relevant market;
c) the impact of the conduct on the number of competitors in the market and their market shares;
d) the impact of the conduct on barriers to entry into the market;
e) the impact of the conduct on the range of services in the market;
f) the impact of the conduct on the cost and profit structures in the market; and
g) any other matters that the Commission is satisfied are relevant.

MCMC published its guidelines following consultations and they are available online.[399] Neither the CMA nor the guidelines makes a distinction based on government shareholding or otherwise of licensees affected by the competition provisions.

The fundamental test in this matter is the 'purpose' of the conduct and the types of conduct covered includes those set out below.[400] Conduct with the purpose of substantially lessening competition is prohibited, irrespective of its effects. Where conduct has more than one purpose, the focus will be on the substantial purpose of the conduct. The particular purpose should be one of the purposes for the conduct and must have been material to the decision to engage in the conduct.[401]

[397] See www.mycc.gov.my.
[398] See CMA, section 134.

[399] See www.skmm.gov.my.
[400] See Guideline on Substantial Lessening of Competition, para 6.1(a).
[401] *Ibid*.

The guidelines further explain and describe the kinds of action that may be covered by this prohibition and are explained briefly below:

a) *Conduct*: this includes decisions to supply or not supply certain goods or services; decisions on price-setting; decisions on the quality of goods or services offered; either making or giving effect to an agreement or understanding, written or otherwise; requiring others to make or give effect to an agreement or understanding, written or otherwise; and making known that an agreement or understanding, written or otherwise, is sought.

b) *Predatory pricing*: prices are set below production costs in the short-term in order to eliminate competitors and increase long term profits.

c) *Foreclosure*: the customer is forced to enter into a long-term supply arrangement with a particular supplier, limiting competition in the market through customer choice restriction.

d) *Refusal to supply*: restricting supply, to actual or potential rivals, goods or services that are necessary for market participation.

e) *Bundling*: a refusal to supply a good or service separately from another good or service, forcing consumers to purchase the bundle rather than just the service they want.

f) *Parallel pricing*: collusion between rivals to vary prices in step.

The guideline also sets out the factors for determining the level of competitive rivalry in a market,[402] including the number of independent suppliers, the degree of market concentration, the level of product or service differentiation, the extent of vertical integration with firms in upstream and downstream markets, and the nature and enforceability of any arrangements between firms in the market that restrict their independence of action. Indicators of the potential level of competitive rivalry in a market include the level of barriers to market entry and exit, the presence or absence of technology, and market developments which are leading or are likely to lead to substitutes.

The CMA sets out conduct deemed to be anti-competitive without regard to purpose, such as rate fixing, market sharing, boycott of a supplier of apparatus, boycott of another competitor, tying and linking.[403]

[402] *Ibid*, para 7.3.
[403] See CMA, sections 135 and 136.

Guidelines on abuse of dominance

The CMA prohibits abuse of dominance. In determining dominance the following issues are relevant:[404]

a) the relevant economic market;
b) global technology and commercial trends affecting market power;
c) the market share of the licensee;
d) the licensee's power to make independent rate-setting decisions; and
e) the degree of product or service differentiation and sales promotion in the market.

The guidelines on abuse of dominance state that there is no presumption of dominance. The prohibition on abuse of dominance goes beyond the general competition provisions of sections 133 to 136[405] and is designed to address situations where the market power of licensees is so extensive that competitive processes are incapable of restraining their conduct in a communications market. In these cases intervention is necessary in order to achieve effective competition. The test for abuse of dominance is one of 'effect' rather than 'purpose'. Thus intention is irrelevant.

This is clarified further in section 137, which refers to a licensee 'in a dominant position in a communications market'. This is not the same as saying that a licensee 'is dominant' in a communications market as it covers both an actual as well as a potential position of dominance[406] and therefore it is sufficient for a licensee to have the ability to take a dominant position. The guidelines explain that the primary characteristic of a firm in a dominant position in a market is the ability to undertake conduct to a significant extent independently of its competitive rivals and its customers (whether consumers or intermediate industry participants), and the pressures they would exert on the firm in a competitive market.[407]

The features that can be evidence of such independence include the ability to independently fix prices, to fix levels of output or the quality of output, to prevent effective competition (either now or in the future), and to force rivals to act in ways they would not have independently chosen.[408]

In cases of abuse of a dominant position, the MCMC is empowered to issue an instruction to a licensee in a dominant position in a communications market to cease conduct that has the effect of substantially lessening competition.[409] The provisions on abuse of dominance

[404] Including any other matters which the Commission is satisfied are relevant; see CMA, section 138.
[405] See Guidelines on Abuse of Dominance, para 5.1.
[406] *Ibid*, para 7.1.
[407] *Ibid*, para 7.2.
[408] *Ibid*.
[409] CMA, section 139.

depend upon the MCMC determining dominance regarding a named licensee in one or more specified markets.[410] A determination is a specific instrument that the MCMC is empowered to issue following a specified procedure laid out in the CMA.

The MCMC must hold a public inquiry involving all relevant stakeholders if the matter is of significant interest to the public, or to current or prospective licensees.[411] Submissions may be made within a period of not less than 45 days and a ruling is issued within 45 days of the conclusion of an inquiry. A report on the inquiry is issued 30 days after the close of the inquiry and these reports are also included in the register. It may be said that the processes in the CMA are thus transparent. The initial dominance ruling was issued on 22 December 2004 and the following licensees were found to be in a dominant position in the specified communications markets:

Licensee	**Communications Market**
TM	Fixed line telephony market
TM Celcom (Malaysia) Berhad Celcom Transmission (M) Sdn Bhd TM Cellular Sdn Bhd Mobikom Sdn Bhd Maxis Broadband Sdn Bhd Malaysian Mobile Services Sdn Bhd Maxis Mobile Sdn Bhd Maxis International Sdn Bhd Digi Telecommunications Sdn Bhd TTdotCom Sdn Bhd AtlasONE Sdn Bhd NasionCom Sdn Bhd Sacofa Sdn Bhd TH-NSTC Sdn Bhd	Interconnection market for wholesale call termination and origination in each licensee's respective networks
TM	Analogue leased lines market
TMNet Sdn Bhd TM	Broadband services market
TM	Analogue broadcast transmission market

The ruling applied to all GLCs and other operators under the various categories. In this respect, it is arguable that CN principles were not compromised – all firms, whether or not they had a competitive advantage, were found to be in a dominant position. Furthermore, enforcement was applied to all operators including GLCs and the incumbent, TM. The rulings

[410] CMA, section 137.
[411] CMA, section 55.

were only valid for two years and no fresh rulings have been issued. No rulings have been issued to date under section 139 and this ruling is no longer in force. However, in May 2013 the MCMC issued a tender for consultants to assist in developing new rulings in relations to dominance, thus additional rulings may be expected in the future.

Licensees also have the right to apply to the MCMC for authorisation of conduct that may have the purpose or effect of substantially reducing competition on the basis that it is in the national interest or subject to specific undertakings.[412] There is a requirement for a register of such undertakings but to date there is no such authorisation registered and this may be an indicator that no GLC has acted in an anti-competitive manner and sought coverage under a 'national interest' label. However, sections 139 and 140 envisage the possibility that the objective of promoting competition may be traded off against other objectives.

The guidelines state that the matters to be considered when determining whether a licensee is dominant include the following:[413]

a) the initial likelihood that the licensee will be found to be in a dominant position;
b) whether any person has informed the Commission of any loss or damage allegedly due to conduct by a dominant licensee;
c) whether such conduct has ceased or is continuing, and whether the conduct is likely to recur;
d) whether the relevant market is significant from the perspective of the objective of the Act;
e) whether the likely benefits of Commission intervention outweigh the likely costs of intervention; and
f) whether the licensee is willing to give an appropriate undertaking regarding its conduct in the market.[414]

Examples of conduct tantamount to abuse of dominance set out in the guidelines include excessive pricing, price discrimination, parallel pricing, excessive discounting, refusal to supply network information, refusal to supply new services, refusal to supply a service essential to any connectivity, refusal to share scarce physical resources and reduction in the quality of supply.

Action has been taken against individual licensees for anti-competitive behaviour through rulings issued by the Commission. Much of the information is not in the public domain, for example the initial complaints and the content of any discussions that may have been held

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412 CMA, section 140.
413 Extracted from Guidelines on Abuse of Dominant Position, para 6.1.
414 The provisions on undertakings provide for the relevant licensees to give undertakings on any matter which may be the subject of a voluntary industry code. The provisions cover their registration, content, withdrawal and replacement. See sections 110 and 111 of the CMA.

between the various parties. However two rulings have been issued against Maxis and DiGi respectively. The ruling issued to Maxis[415] merely requires it to cease certain business activities but is issued under section 133 of the CMA, which prohibits conduct that substantially lessens competition. The second ruling is against DiGi[416] issued under section 136, the prohibition against tying and linking arrangements. We understand that other complaints have been made but were resolved before reaching the stage of the MCMC having to issue rulings.[417] It is difficult to assess this matter as the decisions are not publicly available and no appeals have been heard although the appeal tribunal was established in 2009.[418]

3.2.3 Access

Access regulation is an example of *ex ante* regulation by the MCMC and includes an access list and mandatory access standards. Access covered by the access list is mandatory and subject to the standard access obligation set out in section 149 of the CMA. The section provides that access to those facilities and services on the access list should be provided on reasonable terms and conditions, on the same or more favourable technical standard and quality as provided on the access provider's network facility or network services, and on an equitable and non-discriminatory basis.

The MCMC is authorised to issue the access list and mandatory standard rulings. The access provision is a good example of measures to facilitate the levelling of the playing field by providing access on an equitable and non-discriminatory basis. The process for determining an access list is transparent, involves all stakeholders and consists of a public inquiry and also a written report[419] at the end of the inquiry.

A similar process applies to the determination of access standards, which are compulsory standards. The CMA allows for non-mandatory codes to be written by the relevant industry forum and also provides an incentive for licensees to abide by such codes by providing that compliance with a voluntary industry code is a defence in law.[420] This compliance defence also applies to mandatory standards.[421]

At this stage it is useful to consider the structure of the industry forum and voluntary industry code scheme set out in the CMA. The CMA provides for the establishment of four industry

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[415] See Direction No. 1 of 2006.
[416] See Direction No. 1 of 2007.
[417] These complaints could well have been against GLCs but as these issues were resolved without the need for formal rulings, the information is not in the public domain.
[418] See Appeal Tribunal Regulations 2009.
[419] See description of process in relation to the discussion on determinations of dominance as explained previously.
[420] CMA, section 98(2).
[421] CMA, section 108.

forums: the access forum; the technical standards forum; the consumer forum; and the content forum.

These forums include all relevant stakeholders, have a constitution and are capable of performing as required under the CMA.[422] The access forum and the technical standards forum are companies under the Companies Act 1965, whilst the consumer and content forums are registered associations under the Societies Act 1966. Each forum comprises interested parties that make rules which they agree to abide by. The effectiveness of the forums is subject to the interest and obstructionist behaviour of major licensees.

While the forums have been established to provide fair and open opportunities for all licensees, it is perhaps unrealistic to expect licensees that range from the incumbent to small new licensees entering the market for the first time to play equally strong roles. Furthermore, there is a cost associated with involvement in such activities, both in terms of staffing as well as time and expertise, and not all licensees, particularly small start-ups, are able or view themselves as needing to participate. This results in a 'usual suspects' type of membership, with groups possibly driven by conflicting interests or more powerful groups wielding influence over smaller groups.

Similar challenges appear to apply to the civil society representatives in the forums, as they are usually volunteers in contrast to the staff of large licensees who can afford both the time and sometimes the expense of attendance. Nevertheless the consumer forum and the content forum have made great progress in producing a Consumer Code[423] and Content Code[424] respectively, and these have been duly registered by the MCMC.

The Commission may issue mandatory standards for any matter that is subject to a voluntary industry code if satisfied that the voluntary industry code has failed and will continue to fail, or if the Commission receives a direction from the Minister.[425]

The mandatory standard must specify the class of licensees who are subject to it and as stated previously, pursuant to section 108 of the CMA, compliance with a mandatory standard is a defence against any prosecution, action or proceeding taken against a person subject to it.

In relation to access regulation, mandatory standards, being determinations by the MCMC, follow the process as previously discussed. These have been issued for access generally and access pricing in particular. Mandatory standards have also been issued on technical standards and consumer protection matters.[426]

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422 CMA, section 94.
423 See www.cfm.org.my.
424 *Ibid*.
425 See Ruling No. 1 and 2 of 2003.
426 See register of rulings on MCMC website.

The Malaysian Access Forum has tried several times, without success, to prepare a voluntary industry code. Due to the time taken to establish the forum and the various disagreements at the forum level, the MCMC issued an Access List and a mandatory standard on access in lieu of a voluntary access code.

3.3 *Technical regulation*

Technical regulation covers the use and issuance of spectrum and numbers as well as matters dealing with technical standards which are set out below.

3.3.1 Spectrum

The MCMC has issued a broad Spectrum Plan and subsidiary technical documents, which form the framework for management of the resource. The Communications and Multimedia (Spectrum) Regulations 2002 establish the framework for the issue of assignments, along with the nature and conditions attached to each type of assignment.

The CMA introduced three types of assignments, namely: the spectrum assignment, the apparatus assignment and the class assignment. The differences between these assignments are:

a) A spectrum assignment (SA) confers rights on a person to use one or more specified frequency bands for any purpose consistent with the assignment conditions. Its maximum tenure is 20 years.

b) An apparatus assignment (AA) confers rights on a person to use the spectrum to operate a network facility of a specified kind at a specified frequency or in any specified frequency band or bands subject to conditions imposed by the Commission. Its maximum tenure is five years.

c) A class assignment (CA) confers rights on any person to use any frequency band or bands for a specified purpose.

The rights to these assignments range from tenures of five to twenty years. Section 173 defines how the spectrum is to be used and the methodology for assignment and reassignment of the spectrum. The Spectrum Plan also includes procedures for Spectrum Assignments and Apparatus Assignments, which can be by way of auction, tender, at a fixed price determined by the Minister or at a fixed price determined by the Commission. Auctions or tenders for the allocation of large chunks of spectrum were introduced by the CMA. Details of how these auctions and tenders are to be carried out are outlined in the Communications and Multimedia (Spectrum) Regulations 2000. The allocation of the 3G spectrum was the first implementation of the tender method of allocating spectrum. This was done in 2002 and again in 2005 following the process laid out in the Spectrum Plan and the Spectrum Regulations. While these provisions implicitly recognise CN principles, their practical application has not been as clear, as illustrated by the second case study below.

3.3.2 Numbers

Section 3 of the CMA defines ‘number’ as a number, letter or symbol. This caters to the analogue and the digital era, as the definition can easily cover electronic addresses. There is also exists a Numbering and Electronic Addressing Plan, which covers matters set out in section 180 of the CMA, namely the use of different numbers and electronic addresses for different kinds of services, as well as the assignment, transfer and use of assigned portability of numbers and electronic addresses. It also provides for the charging of fees for the assignment and transfer of numbers, which may be imposed by the Commission.

Number portability applies to mobile telephony services in Malaysia but not to fixed line services. This is hardly surprising since TM is by far the largest PSTN service provider and porting is not a real possibility, due to a lack of competition. Therefore, in general there has been no issue of a lack of competitive neutrality as regards numbers.

3.4 *Consumer protection*

The CMA contains consumer protection provisions that cover the areas of consumer rights and disputes, the Consumer Forum and voluntary codes, rate regulation, and required applications services, for example, emergency services and universal service provision.

The consumer protection provisions, by their very nature, are applied across the board with no exception for GLCs and are therefore not an issue from a CN perspective.

One point of note is that unlike other voluntary industry codes, the consumer code is mandatory in nature (despite its name) and is a standard licence condition. This is pointed out in the Explanatory Statement to the Bill, where it is stated that ‘[w]hile compliance with codes is generally voluntary, the relative weakness of consumers justifies a more direct approach’.[427]

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[427] See para 113.

3.5 *Social regulation*

Social regulation covers matters relating to content and there are very few exemptions granted. This is not a CN issue in Malaysia.

4. CMA Case Studies

Having set out the legislative framework of the CMA in relation to the economic, technical and social regulations and consumer protection provisions that impact on CN principles, this fourth section will provide three case studies to illustrate the extent to which CN principles have been applied in practice. These studies relate to High Speed Broadband, Spectrum and Netbooks.

4.1 *High Speed Broadband network*

In 2008, the Government of Malaysia and TM proceeded with a High Speed Broadband (HSBB) programme to be rolled out on a public-private partnership model, which had a positive take-up.

From the perspective of CN, the issue is whether and why the project was not put out for tender but rather transacted on an agreed basis with TM and later announced. It is of course possible that there may have been no takers as HSBB is a very expensive proposition. Nonetheless, in the absence of a more transparent decision-making process, the government lays itself open to criticisms of favouring the GLC, that is, the incumbent.

Through Ruling No. 1 of 2008, the Minister directed the Commission to defer the implementation of full access to several specified services on the HSBB network for seven years, until 2015. When the access list was reviewed in 2009, HSBB was included, thereby applying standard access obligations to the HSBB network and related services but the application of the principle was deferred as required by the Minister’s ruling. It should be noted that the reason for this deferment was, among other things, to take into account the effect on infrastructure investments. The obligation to open up access to competitors is seen to be a real obstacle to infrastructure investment by telecommunication companies.

Thus while it could be alleged that this deferment of total access, and enabling access to be on a commercial and not regulated price, may be a CN issue, it should also be noted that this ruling is limited in time.

4.2 *YTL spectrum*

In late 2010, there was much media publicity concerning spectrum rights given to a company, YTL Communications Sdn Bhd, in the 700 MHz band. There were allegations of a lack of transparency in the assignment, the negative effect this assignment would have on the progress of the expansion of services by established telecommunication companies, particularly for Long Term Evolution (LTE) services, and the lack of consultation. The matter became so controversial that it culminated in a meeting between the telecommunications industry and the Prime Minister, who subsequently directed the regulator to review the award and apparently advised the MCMC to consult with the private sector before making the award.[428]

The relevant spectrum forms part of LTE frequencies in other jurisdictions but in the Malaysian Spectrum Plan, they are to be used for broadcast applications. The whole furore could have been avoided if the MCMC had complied with the public inquiry procedure, as the use of the 700 MHz spectrum for broadcast would clearly be an issue for the mobile operators who could have sought an amendment to the Spectrum Plan.

4.3 *Netbooks*

The Universal Service Provision (USP) scheme under the CMA provides for the collection of moneys from licensees towards the USP Fund. All such matters are addressed by way of regulations and rulings resulting from discussions in the early years of the Commission.

In 2010, the use of the USP Fund to give Netbooks to 'underserved groups within the community'[429] gave rise to allegations of impropriety, misuse of funds and favouritism regarding suppliers, as well as improper delivery that resulted in persons not falling within the stipulated group having access to the Netbooks.[430]

Again this is an issue of a lack of transparency and non-application of the appropriate provisions of the CMA, for example, a public enquiry on the expansion of the scope of the USP and its implementation. To resolve the matter, the MCMC held a briefing to members of the media after questions were raised in parliament about the issue.

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[428] See www.themalaysianinsider.com 26 November 2010 and 1 December 2010; and www.malaysia-today.net 29 November 2010.
[429] See section 202 of the CMA for the USP regime.
[430] See www.rockybru.com.my 8 November 2010; and http://muststopthis.blogspot.com/2010/11/usp-what-it-is-supposed-to-and-where-it.html.

5. Competitive Neutrality in Malaysia

This section examines some policy tools and other issues that impact on CN in Malaysia. Four issues will be considered: i) institutional reforms; ii) reducing the government's role in business; iii) corporate governance; and iv) public procurement policies.

5.1 *Institutional reforms*

The importance of CN policies was articulated at the OECD Policy Roundtables on State-Owned Enterprises and the Principle of Competitive Neutrality, as follows:

> Presence of competitive neutrality policies is of particular importance in recently liberalised sectors, where they play a crucial role in levelling the playing field between former state monopoly incumbents and private entrants. Equally important is their effective monitoring and enforcement.[431]

This statement is particularly relevant to the telecommunications industry in Malaysia where some of the chief players competing with private enterprises are GLCs, including TM. Nambiar has expressed concerns as to whether the privatisation process has produced the expected greater economic efficiency, and identified that a crucial problem is the dual role played by the government as decision-maker and final arbiter.[432] In this respect, the CMA confers extensive powers on the Minister in matters relating to regulatory policies, licensing and giving directions to the MCMC. At the same time, the independence of the MCMC has been questioned because the Commissioners are appointed by the Minister. Nambiar proposes institutional reforms and suggests that independent bodies be established. This proposal conforms to OECD's view that besides providing policies to promote CN, effective monitoring and enforcement are important. To do this, it is important that the regulatory body is independent in order to carry out decision-making and arbitrating roles effectively.

5.2 *Reducing the government's role in business*

CN principles are also particularly relevant to Malaysia, as GLC participation in the Malaysian economy has been increasing. According to statistics compiled by NEAC and based on its

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[431] Principle (9), available at: http://www.oecd.org/daf/competition/prosecutionandlawenforcement/46734249.pdf.

[432] Nambiar, Shankaran (2009), 'Revisiting Privatisation in Malaysia: The Importance of Institutional Process' *Asian Academy of Management Journal* 38, pp. 21-40, available at: http://web.usm.my/aamj/14.2.2009/AAMJ_14.2.2.pdf. See also Nambiar, Shankaran (2006), 'Enhancing Insitutions and Improving Regulation: Malaysian Case', East Asian Bureau of Economic Research, Working Paper Series No 4, available at: http://www.eaber.org/sites/default/files/WPS_MAN_2006_4.pdf.

definition of GLCs, as of 14 June 2010 there were more than 445 GLCs. In terms of the impact of GLCs on the Malaysian economy, listed GLCs account for more than 37% total market capitalisation in the Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange), which contributes to 17% fixed capital formation and 10% of Gross Domestic Product. A further eight of the 20 biggest companies listed on the Bursa Malaysia are GLCs. In total there are 53 listed GLCs that account for more than one third of the aggregate market capitalisation of the Bursa Malaysia.[433] The continuing impact of GLCs has raised concerns that GLCs are crowding out private investment.[434] Menon and Thiam provide, for the first time, empirical evidence on the relationship between GLC presence and private investment with findings that private investment has been significantly impacted negatively. According to the authors, 'the preferential treatment accorded GLCs, and the impact that they may have in crowding out private investment, suggests that their superior performance is potentially artificially generated, and comes at a high cost'.[435] Similar concerns about the government acting in the interests of GLCs rather than in optimising social welfare are also raised in Nambiar's paper.[436]

The NEAC recommended that the government review its role in business and this was positively addressed in the Tenth Malaysia Plan (2011-2015), where special mention is made of the need for a clear delineation between regulators and market players, as well as for a review of the role of government as follows:

> Consistent with the objective of promoting a transparent, sound and fair regulatory environment to spur the private sector, a clear delineation between regulator and market players will be introduced. In this regard, during the Plan period the role of government will be reviewed in areas such as public healthcare, electricity supply and *telecommunications.* This will remove distortions, promote healthy competition between all players including GLCs, reduce cost of doing business and create the right demand and factor conditions.[437]

In furtherance of this approach, on 25 September 2010 the government launched the Economic Transformation Programme (ETP) aimed at elevating the country to developed nation status by 2020. This programme will be implemented through six strategic reform initiatives, including initiatives on competition, standards and liberalisation and government's role in business. Of the latter, the first of its three stated aims is to 'avoid crowding out the private sector.' The government's subsequent divestment plan in 2011 identified 33 GLCs for

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[433] See NEAC paper, 'Reengineering the Government's Role in Business, available at its website.
[434] Menon and Ng.
[435] *Ibid*, p. 6.
[436] Nambiar.
[437] Tenth Malaysia Plan (2011-2015), Chapter 3: 'Creating the Environment for Unleashing Economic Growth', p. 92, available at http://www.epu.gov.my/html/themes/epu/html/RMKE10/rmke10_english.html (emphasis added).

divestment.[438] The ETP's 2012 Annual Report highlighted that 15 of these have been completed.[439]

5.3 *Corporate governance*

The OECD Policy Roundtables on State-Owned Enterprises and the Principle of Competitive Neutrality referred to earlier also contain the following principle (principle 11):

> Given the necessary role that many SOEs play in achieving goals of general public interest, which cannot be accomplished by private enterprises, it is important to subject them to appropriate corporate governance frameworks in order to maximise their effectiveness and reduce potential market distortions resulting from their privileged position.

While it does not appear likely, in the immediate future in any event, that Malaysia will embark on a full-scale CN framework, an achievable measure is that proposed in principle 11 of the OECD Policy Roundtables: to subject GLCs to appropriate corporate governance frameworks. Corporate governance processes have been introduced in Malaysia[440] as part of the Transformation Programme for GLCs, which started in 2004,[441] culminating in the launch in 2005 of a Transformation Manual which included the reinforcement of corporate governance. This was followed in 2006 with a series of reference books, namely the Green Book (on enhancing board effectiveness and revamping board practices, processes and initiatives), the Silver Book (clarifying social obligations), the Red Book (focusing on review and revamping of procurement), the Yellow and Brown Books (enhancing operational effectiveness), the Purple Book (optimising capital management practices) and the Orange Book (managing and developing human capital). In 2007, a Corporate Governance Code was established and this has recently been superseded by a new Code on Corporate Governance 2012, issued by the Securities Commission and effective from 31 December 2012. The Code sets out eight principles and 26 recommendations on good corporate governance. Some recommendations include the role and responsibilities of the board, independent directors,

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[438] See: http://etp.pemandu.gov.my/Government%e2%80%99s_Role_in_Business-@Reducing_Government%e2%80%99s_Role_in_Business_(GRiB).aspx.

[439] See http://www.theborneopost.com/2013/03/21/etp-annual-report-2012-highlights-glc-divestments.

[440] Malaysia's progress has been cited in OECD (2010), 'Policy Brief on Corporate Governance of State-Owned Enterprises in Asia: Recommendations for Reform', available at: http://www.oecd.org/countries/philippines/45639683.pdf.

[441] The Economic Transformation Programme is an ambitious plan which is part of a broader and long-term plan to modernise the Malaysian economy. Its implementation is managed and monitored by a high-level committee (Putrajaya Committee (PCG)) which reports to the Prime Minister, is chaired by the deputy Finance Minister and includes representatives from all key SOEs with Khazanah serving as a secretariat and is assisted by external consultants.

commitment of directors and corporate disclosure. However the Code is voluntary and its success will depend on the respective boards and their directors.[442]

Another related feature is the introduction and execution of new key policies, such as the headline Key Performance Indicators (KPIs).[443] A new Directors Academy has been established and at the other end of the scale, a Minority Shareholder Watchdog Group (MSWG) was established in 2000,[444] sponsored by the Securities Commission, Malaysia's capital markets regulator. These efforts seems to be paying off as the Putrajaya Committee reports that GLC net income has risen from MYR 9 billion in 2004 to MYR 20.1 billion in 2011, a growth of 18.2% per annum.[445] However, reports from independent researchers are not so clear; while GLCs are said to be creating better firm value,[446] a performance comparison between GLCs and non-GLCs did not appear to provide clear results.[447]

5.4 *Public procurement*

Public procurement is highlighted as one of the eight building blocks for competitive neutrality identified by the OECD.[448]

The interaction between procurement and competitiveness[449] can be seen from their related goals. Indeed, one of the key principles in public procurement is competition. Competition involves awarding contracts through a process in which the public body sets out its needs, interested firms submit offers, and the contract is awarded to the firm with the best offer. The government enjoys substantial discretion in public procurement, so another main aim is the avoidance of abuses in the process, making transparency the other key principle in public procurement. Procurement opportunities need to be made public and selections made according to clear rules. The two principles of competition and transparency interact;

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[442] In relation to the telecommunications industry, see Hamid, Fathilatul Zakimi Abdul and Ruhaya Atan (2011), 'Corporate Social Responsibility by the Malaysian Telecommunications Firms', *The Special Issue on Contemporary Issues in Business and Economics* 2, pp. 198-208.
[443] See 'Policy Brief on Corporate Governance of State-Owned Enterprises in Asia'.
[444] *Ibid*.
[445] See: http://kperspectives.khazanah.com.my/Get_To_Know_Us-@-Government-linked_Companies_Transformation_Programme_to_Spur_Change.aspx.
[446] Y. W. Lau and C. Q. Tong, 'Are Malaysian Government-Linked Companies (GLCs) Creating Value?' *International Applied Economics and Management Letters* 1:1,: 9-12 (2008) 2, available at: http://econ.upm.edu.my/iaeml/vol1no1/bab02.pdf; see also Yoong Hon, Lee, Tan Hui Boon and Cassey Lee, 'Malaysia's Telecommunications Sector: An Efficiency and Productivity Analysis' available at: https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=ESAM2011&paper_id=12.
[447] Razak, Nazrul Hisyam, Ahmad Rubi Ab and Huson Aliahmed Joher (2011), 'Does Government Linked Companies (GLCs) Perform Better than Non-GLCs? Evidence from Malaysian Listed Companies' *Journal of Applied Finance & Banking* 1, 213-240 available at: http://www.econstor.eu/handle/10419/49040.
[448] OECD, 'Competitive Neutrality: Maintaining a level playing field between public and private business', p. 9-10, available at: http://www1.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/50302961.pdf.
[449] See Cheong, May Fong (2011), 'Goals of Public Procurement: A Fine Balancing Act for Malaysia' *Journal of Malaysian and Comparative Law* 38 pp. 9-24, pp. 12-14.

competition results in best value for tax payers' money in public procurements while transparency in public procurement contributes to an open and competitive environment. It has been said that 'competition is the cornerstone of public sector procurement. It underpins the pillars of fairness and transparency, and is the primary driver of VFM [value for money] in virtually all procurements'.[450]

Malaysia is a member of the Asia Pacific Economic Co-operation Forum (APEC) and has adopted the APEC Non-Binding Principles on Government Procurement. The legal framework consists of the Financial Procedure Act 1957, the Government Contract Act 1949, Treasury Instructions and Circular Letters, which apply to procurement by all federal and state governments and semi-governmental agencies but not to SOEs.[451] This means that the latter are not constrained by the rules on procurement and can obtain their supplies through normal business practices, which will be more conducive towards a CN environment.

6. Conclusion

The discussion in this chapter has highlighted the importance of CN principles in the telecommunications industry in Malaysia, where GLCs compete with licensees made up of private enterprises. A survey of the economic regulatory framework in the CMA shows that as a general rule there is no distinction between the manner in which regulatory principles are set out and applied to licensees that are GLCs and those that are not. All licensees have to comply with the usual business regulations and pay the usual corporate and other taxes. The laws apply across the board to all corporate entities.

From the above analysis of the extent to which CN principles are generally applied in the legislative framework of the CMA and the implementation of the CMA by the regulator, the MCMC, it appears that while the legislative framework inherently reflects concern for CN principles, the implementation of the CMA gives rise to transparency and accountability issues. The way forward is for the MCMC to be clear and consistent with the application of the legal principles embodied in the CMA, whether based on competition or other regulatory provisions. If the MCMC takes positive steps in this direction, the perception deficit may well be overcome.

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[450] Office of General Commerce, United Kingdom, 'An Introduction to Public Procurement', p. 16, available at: http://www.ntac.nhs.uk/web/FILES/InsulinInfusion/nhs__1270725126_Introduction_to_Public_Procure.pdf. The guide provides useful illustrations as to how competition issues should be considered at three key stages of the procurement process: i) pre-procurement; ii) tender process/contract preparation; and iii) contract management.

[451] Parliament of Malaysia, Research Unit/HA, 'Transparency in Public Procurement and Business and Civil Society Oversight', available at: http://corruptionresearchnetwork.org/resources/articles/procurement-issues-in-malaysia.

On a broader front, while current developments in Malaysia's commercial landscape relating to the government's divestiture of GLCs and corporate governance are not explicitly intended to address CN concerns, they contribute to enhancing an environment that seems to align with CN principles. However, ultimately the government's implementation of its divestiture and corporate governance policies will establish the true extent of the application (or otherwise) of CN principles in Malaysia.

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The Role of State-Owned Enterprises in Shaping Vietnam's Competitive Landscape

Nguyen Anh Tuan*

1. Introduction

After decades of pursuing reformist policies, Vietnam still remains a highly concentrated economy. State monopolies exist in various forms, from simple monopolies to complex oligopolies operating across a wide range of sectors. In the early years of transition, following the emergence of private sector enterprises, public sector enterprises are no longer the sole market players.

Nonetheless, state-owned enterprises (SOEs) still play a crucial role as the mainstay of public ownership in the marketplace, ensuring the socialist orientation of the national economy. To serve this goal, during the reorganisation of SOEs from the 1990s to the present, state monopolies have remained in designated 'essential industries', such as electricity, water supply and exploitation of natural resources. In these industries, the state controls the price, production and allocation of inputs and outputs. In other strategic industries, such as petroleum, telecommunications, steel and coal, it is common for a number of autonomous SOEs to enjoy collective monopoly status by taking advantage of the state's subsidies in capital, technology and production materials.

SOEs partly contributed to Vietnam's miraculous economic growth in the 1990s.[452] However, at the same time, state monopolies also harbour some characteristics that may inhibit the formation of a competitive environment.

First, SOEs are not established under the forces of competition but through administrative decisions of state agencies that are burdened with social duties. Therefore, most are inefficient and unable to utilise their economies of scale.[453] The pressure to generate profits to contribute to the state budget forces SOEs to overcome inefficiencies by manipulating their

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* I would like to express my gratitude to Associate Professor Deborah Healey, Faculty of Law of the University of New South Wales for inviting me to participate in this project as well as her valuable comments during the draft of this chapter. I am also grateful to Mr. Logan Leung and colleagues at LNT & Partners: without their help I could not have completed this chapter.

[452] For details, see Fforde, Adam (2004), 'Vietnam State Owned Enterprises: 'Real Property', Commercial Performance and Political Economy', Southeast Asia Research Centre Working Paper Series No. 69, p. 1, available at: http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan024765.pdf.

[453] *Ibid,* p. 15.

natural monopoly status to impose higher prices on consumers and to prevent new entrants to the market.[454]

Second, SOEs are placed under the direct or indirect control of state agencies and local governments,[455] which allows the state to intervene in their operation, thereby eliminating actual competition among them. This creates propitious conditions for the formation of state cartels.[456]

Finally, from a bureaucratic viewpoint, state monopolies are considered a 'normal phenomenon' that should be protected, rather than restricted, by law.[457] Accordingly, SOEs can rely on support from bureaucrats to impede the development of private sector enterprises.

These facts have presented the Vietnamese government with the dilemma of finding ways to regulate state monopolies. On the one hand, there was concern that retaining state monopolies across a wide range of sectors would lead to market failures and hamper the fostering of a competitive environment in Vietnam as a whole. These concerns led to calls for a specialised law, similar to the *Sherman Act* in the US, which allowed for effective control of state monopolies and limited the state's intervention in the operation of the relevant markets.[458] On the other hand, policy-makers were reluctant to abolish the monopoly position of those SOEs because of the crucial role they play in preserving national economic goals and the social orientation of the economy. Therefore, it was suggested that state

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[454] For details, see Pham, Alice (2006), 'The Development Of Competition Law In Vietnam In The Face Of Economic Reforms And Global Integration', *Northwestern Journal of International Law and Business* 26:3, pp. 547-564.

[455] The unique character of SOEs was that they were established by and put under direct control of the central or local governments or other state agencies. Those agencies controlled every important aspect of SOEs' operations, including daily management, personnel, price and output allocation. SOEs' profits (if any) should be remitted to the state budget which can be used to subsidise other SOEs' losses. As a result there was no incentive for SOEs to make profit and most of them were 'loss-making'. Recently, there have been calls for SOEs to be reorganised as autonomous enterprises and their state subsidies removed. However, SOEs are still directed by state agencies through representatives on their management boards.

[456] In this regard, the formation of General Companies 90 and 91 under Decision 90-TTg of the Prime Minister on continuously reorganising SOEs, and Decision 91-TTg of the Prime Minister on modeling business corporations, dated 7 March 1994, is an example. Those General Companies (GCs) are formed by moving SOEs with vertical or horizontal integration into one large holding company for the purpose of creating state conglomerates with the ability to compete with foreign enterprises in both domestic and international markets. Without adequate state control, this is apparently an ideal environment for cartels to flourish, since they can legally fix prices and divide markets or customers. For a useful discussion of SOEs in English, see Fforde, Adam (2004).

[457] Nguyễn Như Phát, Bùi Nguyên Khánh (2001), *Moving to Building Laws on Competition in the condition of transitioning into the market economy in Vietnam*, (Tiến Tới Xây Dựng Pháp Luật Về Cạnh Tranh Trong Điều Kiện Chuyển Sang Nền Kinh Tế Thị Trường Ở Việt Nam), Công An Nhân Dân Publisher, p. 30.

[458] Phạm Duy Nghĩa (2002), *Vietnamese business law in transition*, Thế giới publisher, Hà nội, p. 67-68.

monopolies be maintained in strategic sectors or certain industries that require large capital investment.[459]

Another remarkable characteristic of Vietnam's market is the newly established private sector enterprises, including domestic and foreign invested enterprises, as a promising force to enhance economic growth in the future. Trade liberalisation has contributed to rapid growth in the private sector and this sector has quickly become the most dynamic part of Vietnam's fast growing economy.[460]

The presence of private sector enterprises has brought about vigorous competition in many industries. However, most private domestic enterprises are small- and medium-sized[461] and lack competitive capability.[462] Moreover, there are still a number of administrative barriers hindering the development of private enterprises and distorting a fair competitive environment between private enterprises and their public counterparts, such as discriminatory policies in bank credit, land leasing, allocation of export quotas and tariffs.[463] Hence, creating a level playing field for private and public enterprises has become a central issue of discussion among policy-makers and scholars over the years.

Before passing Vietnam's Competition Law, the government took steps to create a level competitive environment for the private sector by limiting the scope of state monopolies and abolishing many administrative measures that were deemed favourable for the public sector. Nevertheless, a competition law is still needed to prevent bureaucrats from intervening in business in the market, as well as SOEs from abusing their natural monopoly status to exclude and eliminate private competitors.

Vietnam's proactive integration into the global market economy was also a factor in the process of drafting a competition law.[464] In general, international economic integration is advocated and considered as a means of enhancing domestic economic growth and

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[459] Nguyễn Như Phát, Bùi Nguyên Khánh (2001), p. 131.

[460] According to a survey by the Asian Development Bank, during the 10-year period from 1995 to 2005, the private sector has outpaced the public sector, and as of November 2005, it accounted for more than 50% of GDP, 27% of total capital investment and over 90% of the workforce (Asian Development Bank (2005), *2005 Vietnam Private Sector Assessment*, p. 3).

[461] In Decree 90 of the government dated 23 November 2004, a small- or medium-sized enterprise is defined as having a register capital of less than 10 billion VND or employing less than an average of 300 employees in a year.

[462] In 2003 there were only 3,325 domestic large enterprises out of a total 72,012 operating businesses, and very few of them were fully privately-owned with more than 300 employees. See Asian Development Bank (2005), pp. 17-18.

[463] Asian Development Bank (2005), p. 48.

[464] World Bank, Asian Development Bank and UNDP (2000), *Vietnam Development Report 2001, Vietnam 2010: Entering the 21st Century – Pillars of Development*, Joint Report of Consultative Group Meeting for Vietnam, 14-15 December 2000, pp. 21-22.

alleviating poverty.[465] However, Vietnam also had to open up to foreign investment in a wide range of sectors and remove protection measures for domestic enterprises.[466] This led to concerns amongst domestic protectionists that the presence of highly competitive foreign invested enterprises (FIEs) may bring about excessive competition in the market and eliminate domestic enterprises. Accordingly, it was argued that this would compromise the policy of building an independent and self-reliant economy as stated in the Constitution.

On 9 November 2004, Vietnam's National Assembly passed the Law on Competition. The enactment of a competition law was a momentous event at the time, and will continue to be regarded as such in the future as it simultaneously affirmed the state's critical role in economic management (facilitatory regulation) and was the cornerstone of building a level playing field between SOEs and private sector enterprises.

However, the law raises a number of complex and important questions, which may remain unanswered for years to come. Will the state use the Law on Competition as a sword to allow regulators and corporate claimants to challenge anti-competitive behaviours? Or will the Law on Competition be a shield to protect SOEs from foreign and domestic competition in the name of 'small- and medium-sized enterprises'?

This chapter pinpoints the legislative and administrative measures that the Vietnamese authorities have employed to create advantages for SOEs over their private counterparts. This is demonstrated through the case study of Viettel Corporation in the telecommunications industry. Comments on the possibility of implementing a competitive neutrality policy in Vietnam and recommendations for the country will also be included.

2. The Nature of SOEs in Vietnam

2.1 *Overview*

The General Statistics Office of Vietnam maintains records of the number of SOEs present in Vietnam in any given year. In 2012, the number of SOEs present in Vietnam was 4,715, composed of the following types of enterprise:[467]

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[465] See Gillespie, John and Pip Nicholson (2005), *Asian Socialism and Legal Change: The Dynamic of Vietnamese and Chinese Reform*, Asia Pacific Press at the Australian National University, pp. 57-59.
[466] World Bank, Asian Development Bank and UNDP (2000), p. 24.
[467] General Statistics Office, *http://www.gso.gov.vn/default.aspx?tabid=382&idmid=2&ItemID=12481* (29 June 2012).

	SOEs
Nationwide (Total)	**4715**
Nationwide (excluding unverified enterprises)	**4505**
Enterprises in operation	3807
Enterprises that have been registered but are not in operation	26
Enterprises that have been suspended	35
Enterprises pending dissolution	637
Unverified enterprises	210

2.2 *Forms of SOE*

In Vietnam, SOEs are established in one of two forms:

1. The first form, **National Champions**, comprises pilot state-owned economic groups and SOEs established under the Prime Minister's Decision No. 91/TTg and Decision No. 90/TTg respectively, both dated 7 March 1994.

    a. **State-owned economic groups** (so-called '91 Corporations'): Decision No. 91/TTg was issued with the aim of piloting the establishment of state-owned economic groups in Vietnam. Under this decision, state-owned economic groups were established on a trial basis by the Prime Minister in several ministries and in Ho Chi Minh City.[468] These groups are required to satisfy the following requirements:
    - Having legal capacity;[469]
    - Being comprised of at least 7 business enterprises;[470]
    - Having a minimum capital amount of VND 1,000 billion;[471] and
    - Having a management board comprising 7–9 members appointed by the Prime Minister.[472]

    Article 2(2) of Decision No. 91/TTg requires that '[t]he formation of a group must ensure the restriction of both monopoly and uncontrolled competition.'

[468] Decision No. 91/TTg, Article 1.
[469] *Ibid*, Article 2.
[470] *Ibid,* Article 2.3.
[471] *Ibid*.
[472] *Ibid*, Article 2.5.

However, on 5 November 2009, the Government issued Decree No. 101/2009/ND-CP to pilot the establishment, organisation, operation and management of state-owned economic groups in more detail than Decision No. 91/TTg and in line with regulations governing Vietnamese enterprises.

Decree No. 101/2009/ND-CP imposed tighter controls on the establishment of state-owned economic groups, including requiring the groups to maintain the capacity to develop certain sectors. The purposes of establishing these state-owned economic groups are to:

- concentrate investment and mobilise resources to form groups of large companies in key industries and economic sectors which need to be developed to enhance competitiveness and international economic integration;
- play a role in ensuring balance in the national economy, high-tech applications and create incentives for the development of other economic sectors and the whole economy;
- promote links in the value-added chain and the development of other economic sectors;
- strengthen effective management and supervision of capital assets invested in the group members; and
- create a base from which to continue improving policies and laws on corporations.[473]

State-owned economic groups are established and maintained in strategic industries that are essential to economic development.[474]

b. **State-owned enterprises** (so-called ‘90 Corporations’): Decision No. 90/TTg was issued with the aim of guiding the restructuring of SOEs in Vietnam. SOEs may be

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473 Decree 101/2009/ND-CP dated 05 November 2009 on the establishment, organisation, operation and management of state economic groups, Article 1 (Decree 101).

474 *Ibid*, Article 3:
Scope of Application
This Decree applies to the State owned economic group established by the Prime Minister in the following major business lines:
1. Post and telecommunications and information technology;
2. Building and ship repair;
3. Production, transmission, distribution and trading of electricity;
4. Survey, exploration, exploitation, processing and distribution of oil and gas;
5. Survey, exploration, mining, mineral processing and coal;
6. Textiles;
7. Planting, harvesting and processing of rubber;
8. Manufacturing and trading of fertilizers and other chemical products;
9. Investment and real estate business;
10. Industrial construction and mechanical engineering;
11. Finance, banking and insurance;
12. The lines under the decision of the Prime Minister.

established under this decision by ministries and local People's Committees. These 90 Corporations are smaller than 91 Corporations in scale and need to satisfy the following requirements:

- Having at least five members that have a relationship in finance, investment development programme and supply, transportation, information and training services;
- Having a minimum capital amount of VND 500 billion; and
- Having its directors and staff appointed by the ministers and head of the local People's Committees.

The purposes of establishing 90 Corporations are largely similar to those for the 91 Corporations.

2. The second form comprises **SOEs established under the Law on State-owned Enterprises** (2003), including state companies, joint stock companies and limited liability companies.

a. **State companies:** State companies are established in areas that supply essential products and services, apply advanced technology, create competitive edges and encourage rapid economic development in geographical areas subject to difficult socio-economic conditions.

State companies were formerly established in accordance with the Law on State-owned Enterprises (1995). This was replaced by the Law on State-owned Enterprises (2003).

Under these laws, the Prime Minister, through his/her decisions, has the capacity to establish large-scale state companies and state companies operating in strategic industries. The heads of government-attached agencies and the presidents of the provincial-level People's Committees have the capacity to establish state companies in other areas.

b. **State-owned joint-stock companies and state-owned limited liability companies**: State-owned joint-stock companies, state-owned one-member limited liability companies and state-owned limited liability companies with two or more members are established under Article 11 of the Law on State-owned Enterprises (2003).

However, the Law on State-owned Enterprises (2003) has been repealed by the recent Law on Enterprises (2005). This law now governs the establishment, management and operation of all types of enterprises, including SOEs.[475] Despite this change, the former still applies in the event of conversion.[476]

There has also been a steady trend towards privatising pure SOEs into joint stock companies. The state's privatisation programme was piloted in 1992 as part of its economic restructuring programme. This programme was officially promulgated through Government Decree No. 44/1998/ND-CP on 29 June 1998, which governs the transformation of SOEs.

The objectives of Decree No. 44/1998/ND-CP were to transform SOEs, of which the state does not need to maintain 100% ownership, into enterprises with multiple owners and mobile private and foreign capital. The aim was to increase the enterprise's financial capacity, renew its technology and renovate its management system.

The latest regulation regarding the transformation of pure SOEs is Decree No. 59/2011/ND-CP. Under this decree, the following SOEs may be eligible for privatisation:[477]

- One-member limited liability companies with 100% state capital which are parent companies of state-owned economic groups established under Decision No. 91/TTg and SOEs established under Decision No. 90/TTg;
- One-member limited liability companies with 100% state capital under the administration of ministries, ministerial-level agencies and provincial People's Committee; and
- Enterprises with 100% state capital which have not yet been transformed into one-member limited liability companies.

Privatisation is undertaken through either issuing additional stock to increase capital, selling a part of the state's capital holdings, or any combination thereof.[478]

2.3 *State governance of SOEs*

Under the Law on State Enterprises (2003), SOEs are governed by the state in two ways: through state authorities and as the owner of the SOEs.

For governance through state authorities, particularly the government, state authorities have the right to:[479]

[475] Vietnam, Law on Enterprises 2005, Article 169.
[476] Vietnam, Law on Enterprises 2005, Article 171.2.
[477] Decree 59/2011/ND-CP dated 18 July 2011 on transformation of enterprises with 100% state capital into joint-stock companies, Article 2.
[478] *Ibid*, Article 4.
[479] Vietnam, Law on State Enterprises 2003, Article 87.

- promulgate and organise the implementation of legal documents for the SOE;
- develop planning and strategies for the development of the SOE;
- organise the business registration of the SOE;
- build up and store basic information on the SOE;
- monitor and supervise the business operation of the SOEs after registration to ensure strict compliance with the law;
- draw up plans and organise the training, professional development and raising of business ethics for managers of the SOE;
- promulgate the list of products, financial management systems and preferential policies for public utility products and services from time to time; and
- inspect the operation and settle complaints and denunciations of the SOE.

As the owner of the SOEs, the state can:
- decide to establish SOEs by approving plans to establish SOEs, the charter of the SOEs and appointing managers;[480]
- decide to merge, split or dissolve SOEs in accordance with the principles and time stipulations prescribed by the government;[481]
- decide the initial and additional investment capital, allocation of capital; inspect and supervise the preservation and development of the capital; and approve plans to raise capital and initiate joint ventures;[482]
- decide to apply management models, and appoint, dismiss, reward or discipline key management positions in the business;[483] and
- set prescribed standards and norms, unit wage, salary, bonuses and allowances; and to inspect and supervise the implementation of the SOEs in accordance with the objectives and tasks assigned by the state.

2.4 *State control of SOEs via legal instruments*

In addition to the specific powers discussed above, the government also exercises its control or influence through numerous legal instruments, such as the Law on Price and specialised laws regulating specific strategic industries (e.g. the Law on Telecommunications for telecommunications providers).

The state manages market price mechanisms and regulates prices through the Law on Price in order to review the implementation of price stabilisation. Accordingly, the state may implement measures to stabilise and determine prices for certain goods and services. The

[480] Vietnam, Law on State Enterprises 2003, Article 9.
[481] Vietnam, Law on State Enterprises 2003, Article 75.
[482] Decree 09/2009/ND-CP dated 05 February 2009 issuing the regulations on financial management of SOEs.
[483] Vietnam, Law on State Enterprises, 2003, Article 21.

goods and services that are subject to price stabilisation are those deemed essential to production and human lives, and fall under two categories: (a) raw materials, fuel, materials and services for production and circulation, and (b) goods and services that meet the basic needs of human sustenance.

The state will also determine the price or set a price limit for (a) goods and services under a state monopoly in production and business sectors; (b) important natural resources; and (c) national reserves, products, services and public service industries financed by the state budget. Goods that are important to production costs include land leases, electricity supply and communication services to be determined by the state. In addition, the state may supplement the goods and/or services subject to price determination or stabilisation by obtaining approval from the National Assembly Standing Committee. The law creates the legal basis for the state to control price competition in the market to retain inefficient SOEs. Examples can be found in the petroleum retailing, gold trading and mining industries.

With regard to telecommunication services specifically, regulations require the state to hold a dominant number of shares in service providers with particularly important network infrastructures.[484] For economic concentrations in this field that fall within the scope of the Law on Competition, the Law on Telecommunications provides that the Ministry of Information and Communications shall assume prime responsibility for coordinating with the Ministry of Industry and Trade to regulate these activities.

Article 19.5 of the Law on Telecommunications requires telecommunication enterprises that have a combined market share of 30 to 50% in the relevant services market to provide prior notice to the Ministry of Information and Communications of any intended economic concentration. Furthermore, the enforcement of Article 25.1 of the Law on Competition (exemption for economic concentration) in telecommunications activities must be approved in writing by the Minister of Information and Communications.

In 2011, a controversial acquisition by Viettel (a military corporation) over EVN Telecom (a subsidiary of Electricity of Vietnam (EVN)), which had the alleged effect of increasing Viettel's market share to over 50% in 3G frequency resources, was conducted without the exemption procedures from the competition authority.[485] The acquisition, however, was approved by the Prime Minister and Minister of Information and Communications.

[484] Vietnam, Law on Telecomunications 2009, Article 17.
[485] Economics (2013), *http://www.economics.com.vn/2012/08/viettel-is-likely-in-pole-position-to.html*, 13 November.

2.5 *The application of competition law to SOEs*

Article 2 of the Law on Competition states that all organisations conducting business will be governed by it. Accordingly, SOEs and their activities fall within the governing scope of the Law on Competition.

As a matter of principle, the Law on Competition only applies to entities conducting business activities and accordingly, entities that do not conduct business activities do not fall under the law's scope. However, the Law on Competition does not define what business activities entail. Nevertheless, according to the Law on Enterprises, 'business activities' refers to the continuous implementation of one, several or all stages of an investment process, from the production to the sale of products or provision of services on the market for profit purposes.[486]

The Law on Competition preserves the right of the state to decide the price, quantity, volume and scope of goods and services in state monopoly sectors, and to control enterprises that produce or supply public utility products or services by placing orders, assigning plans or conducting tenders in accordance with prices or fees stipulated by the state.[487] It is noted that these provisions are not applicable to SOEs when they are conducting business activities outside state monopoly sectors *and* are activities other than the production or supply of public utility products or services.[488] There is also no business test or equivalent method of checking what is applicable in this regard.

In principle, SOEs established to pursue commercial purposes that do not fall within 'State Monopoly Sectors' are put under the scrutiny of the law. However, the term 'State Monopoly Sectors' itself is not clear and thus, as will be discussed below, this has led to different interpretations between state authorities, scholars and businesses. Moreover, the scope of the application of this provision is also undefined – for example, does such immunity also apply when such enterprises carry out unfair competition practices?

Under Article 6 of the Law on Competition, government bodies are prohibited from performing activities that affect the competitive environment and enterprises conducting business. If there is a violation of this provision, the government bodies will be subject to administrative sanctions in accordance with Article 120 of the Law on Competition, which specifically addresses the handling of violations by state agents. Accordingly, the Law on Competition does not directly govern the activities of state bodies.

[486] Vietnam, Law on Enterprises 2005, Article 4.2.
[487] Vietnam, Law on Competition 2004, Article 15.1-2.
[488] Vietnam, Law on Competition 2004, Article 15.3.

2.6 *The advantages of SOEs in the market*

SOEs have several advantages arising from their government ownership.

With regard to competition law enforcement, SOEs may leverage government ownership to circumvent the scrutiny of the Law on Competition. This may be done by obtaining an administrative ruling from the Prime Minister or the administrating ministry. The recent acquisition of EVN Telecom by Viettel illustrates this problem.[489]

SOEs may also enjoy the following advantages in the market:

- As SOEs receive investment from the state budget, the management board or the representative of the state owner is subject to less pressure on efficiency and risk management of the company's business activities;

- As many SOEs hold a dominant position in several key industries, they often do not encounter competition in the market and the threat of being excluded from the relevant market. The risk of bankruptcy is hedged as the state has the capacity to protect the enterprise through capital injections, etc.

- In some industries such as transportation, aviation and telecommunications, SOEs are given priority to use existing infrastructure, which has been directly invested in by the state.

- State authorities can give priority to SOEs to participate in many government projects, in contrast to private companies.

- SOEs are able to raise capital through loans at low interest rates (sometimes even interest-free loans) with high credit lines, particularly loans from Development Supporting Funds.[490]

- SOEs are often subject to a lower corporate tax rate (although this is less common nowadays).

- SOEs have easy access to state funds, real estate and other resources.

[489] Talk Vietnam http://talkvietnam.com/2011/12/viettel-evn-telecom/#.UgoQDG3Tr0c, 5 December 2011.
[490] http://kinhdoanh.vnexpress.net/tin-tuc/vi-mo/quy-ho-tro-phat-trien-hoat-dong-khong-loi-nhuan-2678135.html, 6 March 2014.

2.7 *Difficulties governing SOEs*

There is a distinct lack of legal framework for the establishment, management and operation of SOEs. Most regulations governing SOEs exist 'under the radar' and are often ultimately subject to the decisions of the state authorities, particularly the Prime Minister.[491] Therefore, SOEs often lack adequate control mechanisms and the responsibilities of managers are not often closely regulated.

Corporate governance in SOEs is not effective as there is often a thin line between the management function and administration function of the Government and ministries.[492] Managers of SOEs often lack managerial experience and the capacity to perform business administration as they are appointed without any testing of sufficiency of conditions and criteria. Therefore, it is not unheard of to have large-scale SOEs being managed by individuals who do not possess adequate managerial experience.

There are also concerns over the lack of transparency in the operation of SOEs, resulting from low-level inspections and auditing procedures.

2.8 *Neutralising the advantages of SOEs for a fair playing field*

2.8.1 Analysing the net competitive advantages of SOEs

Having a net competitive advantage is an irrefutable privilege of SOEs, and it varies from visible incentives to latent conveniences. In Vietnam, such favourable treatment comes under the following forms, despite the legal bases for such advantages not always being clearly stipulated:

- **Access to capital sources at low interest rates, to corporate bonds with state guarantees or to foreign exchange at lower rates**

  Under this treatment, SOEs are able to enjoy loans from commercial banks without strict corporate disclosure requirements and government supervision. Loan financing is a more convenient means of subsidising than financing through Initial Public Offerings (IPOs), which requires greater transparency and fairer competition.

  According to an OECS report, SOEs primarily obtain financing through the State Capital Investment Corporation (SCIC), the Viet Nam Development Bank (VDB) and other

[491] SPVN Law, http://spvn.vn/Han-che-trong-quan-ly-doanh-nghiep-nha-nuoc-productview.aspx?cate=108&id=1551, 20 November 2013.
[492] Tien Phong Online (2012), http://www.tienphong.vn/Kinh-Te/598071/Nen-bo-han-co-che-bo-chu-quan-tpp.html, 01 November.

commercial banks.[493] It is reported that in 2009, approximately 20-25% of SOEs' debts were guaranteed by the government, either directly and indirectly.[494]

In addition, the state also provides support for restructuring inefficient SOEs via financial instruments. These include supplementary capital, debt rescheduling, debt waiving and even payment of SOEs' loan obligations by the government. The burden of loans taken out by SOEs on the state budget is illustrated by the amount of foreign loans to SOEs and credit institutions guaranteed by the government in 2011, which constituted 12.8% of Vietnam's foreign medium- and long-term loans. This number had increased by 12.5% compared to 2010.[495]

- **Land assignment or leasing at lower rates**

In the past, SOEs were assigned land for free or for lease at lower rates. Currently, although specific land incentives for SOEs are not provided under national regulations, SOEs still enjoy these preferential treatments. In addition, in practice, SOEs still enjoy such advantages through particular approvals from the central government or local governments on a case-by-case basis. These advantages, which may vary from company to company, are recorded on the SOE's business registration certificate.

- **Freedom from strict supervision and management**

Under Decree No. 101/2009/ND-CP, economic groups are established by the government and only have to report to the government and the Prime Minister on important issues. These include, among others, their business activities, investment plans and investment structure of their core and non-core business, capital mobilisation, bank, real estate and stock market activities, and the form and level of cooperation among enterprises within each economic group.[496]

Accordingly, SOEs and economic groups are often free from the supervision of functional third parties such as the state auditor.

In addition, profits (if any) are often retained to increase SOEs' capital or to make investments, instead of paying dividends to the state budget.

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[493] OECD (2013), 'Southeast Asian Economic Outlook 2013: With perspective on China and India', Structural Policy Country Notes, Viet Nam, 2013, p. 13.
[494] OECD (2013), p. 13.
[495] OECD (2013), p. 14.
[496] Decree 101, Article 41.

- **Debt purchases**

  The State Capital Investment Corporation (SCIC) and the Debt and Asset Trading Corporation (DATC) are enterprises established by the government for the purpose of reforming SOEs.

  While the SCIC is the State Capital's representative in enterprises, the DATC's purpose is to manage SOEs' outstanding debts. These two enterprises were established with the bona fide intention of saving SOEs from insolvency and improving the efficiency of managing the state budget. They have, however, spontaneously become the saviours or an exit route for SOEs when they become buried in bad debt.

2.8.2 Mechanisms for complaints and supervision

Under the current structure, Vietnamese competition authorities include the Vietnam Competition Administration Authority (VCA), which acts as a watchdog, and the Vietnam Competition Council (VCC), a quasi-judicial body.

While the VCA is a department under the Ministry of Industry and Trade (MOIT) and executes its power in line with the MOIT's decisions, the VCC is affected by related industrial policies due to its serving members being from other ministries. This structure imposes barriers on both the VCA and the VCC when executing their role in moderating competition policy.

However, these authorities deal with complaints against anti-competitive behaviour, rather than concerns about government policy conferring competitive advantages on government-owned businesses.

As a matter of law, such complaints may be made pursuant to Article 6 of the Law on Competition, which prohibits state authorities from intervening in market competition. However, this does not appear to be effective in practice.

In 2011, Viettel planned to take over EVN Telecom in both its business lines: mobile and 3G services. Preliminary analysis of the two SOEs showed that if the acquisition took place, the combined market share of Viettel would reach 50% of the total 3G frequency in Vietnam, leading to Viettel holding a dominant market position over other smaller 3G providers. Under Vietnamese competition law, this combination can only be permitted if EVN Telecom could establish that it was at risk of bankruptcy or dissolution. In fact, a policy complaint by Hanoi Telecom Corporation (HTC) against this acquisition was made to the VCA. However, the VCA did not provide an official response to this complaint and the Prime Minister subsequently signed Decision No. 2151/QD-TTg to transfer EVN Telecom over to Viettel.

There are no complaint procedures in place in relation to government policy. According to the current law on administrative procedures, parties may make complaints against a decision to settle a complaint about the handling of a competition decision. Under the common mechanism, a citizen/organisation (i.e. a complainant) may make the initial complaint with the person/body who issued the administrative decision or the agency that managed the person/body who committed the administrative acts. The complainant may file an administrative lawsuit in court. The time limit for settling first-time complaints is set at 45 days for ordinary cases and 60 days for complicated cases.

If the complainant disagrees with the initial complaint settlement decision or the complaint remains unsettled after the prescribed time limit, the complainant may make a second complaint with the direct superior of the person competent to settle the initial complaint or institute an administrative lawsuit. The time limit for settling the second complaint is set at 45 days for ordinary cases and 70 days for complicated cases.

If the complainant disagrees with the second complaint settlement decision or the complaint remains unsettled after the prescribed time limit, he/she has right to institute an administrative lawsuit.

It should be noted that these above rights are only available to citizens/organisations with grounds to believe that an administrative decision or an unlawful act has directly infringed their rights and lawful interests.

2.8.3 Recommended complaint mechanism

In developing countries such as Vietnam, the state plays a significant role in regulating business activities as a part of market reforms.

Due to the lack of a strong and independent judicial system as a check and balance against administrative decisions, complaint procedures against government policy are not really effective in practice. It is expected that industrial policy will be more important than competition policy for maintaining high economic growth. The state-owned sector has long played a central role in leading Vietnam's economic development and it will continue to be entrusted to do so for years to come until there is sufficient confidence in the private sector to assume this role. Until then, administrative measures will be a priority, as the HTC case mentioned above illustrates.

Therefore, a recommended and effective complaint mechanism would be through an international organisation, particularly key donors who can put pressure on the government. The proposal for establishing an electricity trading company is a prime example that supports this recommendation.

In 2008, a proposal for establishing a joint venture enterprise (JVE) to sell and purchase electricity was submitted to the Prime Minister by Electricity of Vietnam (EVN). According to the proposal, JVE would be established in the form of a shareholding company, pursuant to which seven major SOEs (PetroVietnam, Vietnam Coal and Minerals Group, Song Da Construction Corp., Vietnam Posts and Telecommunications Group (VNPT), Vietnam Cement Corp., Vietnam Steel Corp., and Vietnam Machinery Installation Corp) would own a 49% stake and EVN would hold the rest.

If this JVE was established, it would form a monopoly in the market for the sale and purchase of electricity, and would be expected to create inter-brand competition among EVN's affiliates. However, some opposed this plan, arguing that selling and purchasing electricity should not be subject to a state monopoly and asked for the sector to be opened up to competition. This led to heated debate between the two sides for several months. Finally, in the middle of September last year, the Prime Minister ended the controversy by requesting that EVN and other participants cancel their proposal.

From a competition law perspective, this economic concentration is prohibited under Article 18 of the Law on Competition. Its proposal should thus have been lodged at the VCA for review and then submitted to the Prime Minister to determine whether an exemption should be granted. However, in this case, the incumbents ignored the Law on Competition and made the proposal directly to the Prime Minister, thereby promoting the view that SOEs are 'immune' from the application of the Law on Competition. However, one significant turning point in this case was the role of the World Bank. The World Bank's protest against EVN's proposal, which would have created a monopoly had it taken place, managed to attract strong public attention and support and was a major decisive factor leading to a conclusion in favour of the World Bank.

This case demonstrates the importance of public advocacy in promulgating competition law in Vietnam. The concept of competition law should be informed by an understanding of interest groups, development policy and Vietnam's integration into the international economic community. Furthermore, since the ultimate aim of competition law is to promote a fair and free competitive environment for businesses, in cases where competition law cannot be enforced, other methods can be employed to help maintain free competition. In the fight against violations of the Law on Competition, particularly those committed by powerful SOEs, the VCA thus should not stand alone but take advantage of support from the public, business groups and, in particular, foreign organisations that are familiar with the competitive landscape in developed countries.

2.9 *Recommendations for Vietnam*

Considering the key role of major SOEs as the mainstay of the government's policy of promoting a socialist-orientated market economy, implementing a competitive neutrality policy may not be a priority of the Vietnamese Government at the present time.

Like other countries in the region, such as Thailand or Indonesia, Vietnam still lacks the necessary supporting institutions to fully enforce competition law regimes. Instead, at this stage, Vietnam should focus on competition advocacy to create the necessary foundations for a market-orientated economy and hence competition. Those measures should be aimed at boosting the political commitments to market reform, eliminating the barriers to entry and exit, reducing and eventually abolishing the preferential treatments towards SOEs, and welcoming competition policy and competition culture.

This can only be done with a faster equitisation process. The regulatory framework for this process was laid down through the enactment of the Law on Enterprises in 2005, which established a fair basis for all types of enterprises in Vietnam, regardless of ownership type and economic sector. Under the law, all existing SOEs were required to be transformed into joint-stock companies or single-owner limited liability companies by 1 July 2010. The equitisation process has been carried out through divestment in areas unnecessarily controlled by the state such as construction, telecommunications, ports and aviation. Despite the framework having legal backing from 2005, the progress of equitising SOEs has fallen behind the expected schedule.

Another important reform to foster competition is to provide more room for privately-owned enterprises to develop, thereby reducing the impact of SOEs. Under the current regulatory regime, there is no specific provision on the minimum percentage of the state's investment in an SOE's equity. In practice, the extent of state investment in SOEs is still maintained under industrial policy and market entry barriers to private investment. Therefore, the chance for privately-owned enterprises to grow and drive the growth of SOEs is rather limited as the room for private ownership in SOEs is still restricted.

A fair competition culture is established when the state's intervention is clearly identified in terms of its extent and level.

Horizontally, the state's control over prices and its monopoly areas are broad enough to distort the market. Therefore, its right to price determination should cover a smaller list of goods and services, while its monopoly areas should also be reduced in scale. Narrowing the unnecessary monopoly position of the state in the market is obviously an effective measure for limiting the state's intervention in the natural competition environment.

Vertically, there have been few proper mechanisms to protect long-term competition policy from instantaneous industrial policies, which has led to the competition law regime having to give way to exemptions on a case-by-case basis. A mechanism should be set up to ensure that the state's intervention falls within competition protection policy, which provides guidelines and scope for analysis of the circumstances where it is appropriate for exemption to occur.

Since Vietnam has officially participated in the Trans-Pacific Partnership Agreement (TPP), it is also important that the competition agency utilise foreign pressure whenever possible to strengthen its political position and expedite the adaptation process. Meanwhile, amending the Vietnamese Law on Competition for the purpose of adapting to the new state of economic activities, strengthening the investigation capability of competition authorities and promoting advocacy of competition law and policy are also important matters in the long-term plan to strengthen competitive neutrality in Vietnam.

3. Case study: the Viettel Telecommunications Group

This section of the chapter presents a case study of the Viettel Telecommunications Group (Viettel), a leading SOE in the telecommunications industry, to illustrate several specific advantages that SOEs enjoy in practice.

3.1 *The establishment of Viettel*

Established in 1989 as a military corporation trading telecommunications equipment, Military Telecommunication General Corporation (Viettel Corp) was the first telecommunications company in Vietnam to obtain a licence to provide full telecom services to the country in 1995. Viettel joined the telecommunications market in 2000 and quickly became one of the fastest growing telecom operators in the country, with its year-on-year revenue doubling for seven consecutive years between 2005 and 2012.[497]

In 2009, Viettel Corp was overhauled to become Viettel Telecommunications Group (Viettel Group or Viettel) by Prime Minister's Decision No. 2079/2009/QD-TTg dated 14 December 2009. This was done in accordance with the proposal to restructure SOEs, particularly economic corporations and state general companies, from 2011 to 2015 that was approved by the Prime Minister under Decision No. 929/QD-TTg dated 17 July 2012. According to Decision No. 2079/2009/QD-TTg, Viettel is a military-run economic enterprise operating with an initial investment of VND 50,000 billion (approximately USD 2.5 billion) and with its capital fully owned by the state.[498]

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[497] Viettel, *www.viettel.com.vn/About_us.html*.
[498] Vietpress Release, *http://hoso.thongcaobaochi.com.vn/vn/viettel_c121.html*.

The main business lines of Viettel included providing telecom and telecom-IT services, conducting surveys, consulting, designing, installing and maintaining telecom-IT projects, and manufacturing, importing, exporting and supplying telecom-IT materials and equipment.

Fast growth over the last two years has led Viettel to become one of the leading service providers of mobile networks and 3G services in Vietnam, and it maintains a dominant position in the relevant markets. Viettel is also seeking to expand its coverage to international markets, particularly emerging markets. Currently, it has operations in eight markets in Asia, Latin America and Africa, covering a total population of nearly 170 million people. Viettel's target is to be one of the 10 largest global telecom investors covering a population of 300-500 million by 2015.

3.2 *State governance*

The state governance of Viettel is set out under Prime Minister's Decision No. 446/QD-TTg dated 30 March 2011. Accordingly, Viettel is a combination of enterprises operating in the form of a parent company with numerous subsidiary companies. The parent company was established as a limited liability company with one member (the state). Viettel's group is directly managed by the Ministry of Defence (MOD) and operates in accordance with Vietnamese law, the MOD's regulations and its charter approved by the Prime Minister.[499]

Viettel pursues, among others, the objective of being a leading enterprise in promoting the rapid and sustainable development of the telecommunications and information technology industry in Vietnam, as well as enhancing the effectiveness of competition and international economic integration.[500] In addition to pursuing profit-making objectives, Viettel is also required to serve national defence objectives under the direction of the MOD.[501]

According to Article 14 of Viettel's charter, the exercise of state ownership is primarily vested in the Prime Minister, the MOD, the Ministry of Finance, and the Ministry of Industry and Trade. Other ministries, such as the Ministry of Telecommunications, implement state management functions over Viettel's operations within the scope of their authority.

While the Prime Minster is in charge of the overall management of Viettel, the MOD is responsible for its organisational structure and operations. The Ministry of Finance monitors financial matters, including the use of state funding and foreign loans, while the Ministry of Industry and Trade to sets and implements Viettel's business.

[499] Charter for organisation and operation of the Military Telecom Corporation issued along with Decision 446 (The Charter), Article 3.
[500] The Charter, Article 4.2.
[501] The Charter, Article 5.

At the organisational management level, Viettel is led by a General Director (instead of a Members Council as with other state-owned groups). The MOD appoints and dismisses the General Director of Viettel, subject to the Prime Minister's approval. The General Directors, who are military officers, constitute the authorised representative of the state ownership of the company and are responsible for managing its daily operations.[502]

As a matter of procedure, the General Director proposes the goals, development strategy, long-term planning, production planning, five-year business development plans and business lines, which are submitted to the MOD for evaluation, and to the MOF and MOIT for opinions. The Prime Minister issues the final approval after consultation with the relevant ministries.

3.3 *Overview of the Vietnamese telecommunications market in the early 2000s*

In the 1990s and early 2000s, the Vietnamese telecoms market was monopolised by VNPT under two mobile service brands: Mobifone and Vinaphone. At the time, telecommunication prices in Vietnam were among the highest in the region and demand had quickly exceeded service providers' supply capacity.[503] In 2004, both Mobifone and Vinaphone announced that they were unable to accept new subscribers, which provoked intensive public criticism, with many people calling for monopoly-busting in the telecoms market.[504]

Due to constant complaints by the public media, the state decided to open the market to competition by allowing other telecom service providers to enter. As a result, Saigon Postal Corporation (SPT) and Viettel Corp were licensed to provide telecom services at almost the same time to compete with Mobifone and Vinaphone. SPT formed a joint venture with Korean partner, SKTelecom, under a Business Cooperation Contract to provide the S-Fone network. Viettel Corp operated the Viettel network using existing military infrastructure.

To secure their market share, VNPT's subsidiaries took many steps to prevent younger networks from entering the market and expanding. These measures included endeavours to impede their scalability by delaying discussions with provincial posts, increasing commission fees and refusing location hiring proposals.[505]

In 2004, S-phone applied to connect with two of VNPT's networks but was refused for a technical reason: that it would be difficult to connect S-fone's CDMA network to VNPT's GSM

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502 The Charter, Articles 26-30.

503 Ict News (2013), http://ictnews.vn/home/Vien-thong/5/20-nam-di-dong-Viet-Nam-Don-bay-nam-o-dau/111420/index.ict, 23 August.

504 Tuoi Tre Online (2004), http://tuoitre.vn/Chinh-tri-Xa-hoi/32969/co-che-doc-quyen-goi-qua-kin-nganh-buu-chinh-vien-thong.html, 14 May.

505 Tuoi Tre Online (2005), *http://tuoitre.vn/Chinh-tri-Xa-hoi/86085/vu-ong-doc-quyen-vnpt-bi-to-cao--su-that-duoc-phoi-bay!.html*, 30 June.

network. It is noted that another CDMA network of VNPT (Cityphone) was permitted to connect to the Vinaphone and Mobifone networks. Therefore, it was not certain whether the refusal on the basis of technical difficulties was just a guise to refuse the application.

S-fone had to indirectly connect to VNPT's networks through an intermediate switchboard managed by VNPT at a cost of VND 250/minute, leading to an extra payment of VND 2 billion per month by S-fone. As a result of this unnecessary monthly payment, S-fone asked the Ministry of Postal and Communication (now the Ministry of Information and Communication (MIC)) to intervene. However, it did not receive any support.[506]

3.4 *Taking advantage to penetrate the market*

VNPT applied similar market foreclosure measures against Viettel. However, in the early days, the government applied administrative measures to counteract VNPT's measures.[507]

For example, Viettel encountered similar problems with synchronising its network with Mobifone and Vinaphone. According to Viettel's representatives, it was allowed to connect with VNPT's networks at an extremely slow rate of progress that would have taken approximately 40 years to fully synchronise. However, unlike S-Fone, Viettel was able to ask the deputy minister of MIC to chair a meeting with VNPT on 29 June 2004 to resolve the outstanding issues. At the meeting, the MIC directed VNPT to amend the current contract with Viettel so that the synchronisation could be completed faster at a lower fee fixed by the MIC.[508]

Viettel also received intensive support from the MOD in finance and resources. In addition to the privilege of being able to exploit existing infrastructure which was built for military use, Viettel was able to save fixed costs through late payment arrangements with Huawei, a major Chinese telecom equipment supplier, under the MOD's guarantee.[509]

By utilising these advantages, Viettel steadily expanded its network, developed its infrastructure and applied competitive pricing policies to compete with VNPT's networks. By operating at low cost, Viettel was also successful in pushing the networks into price competition to expand its market share. S-Fone was gradually pushed out of competition before completely being excluded from the market in 2012 because of the high cost structure.

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[506] Sai Gon Giai Phong Online (2013), *http://www.sggp.org.vn/trithuccongnghe/nam2004/thang11/24082/*, 15 November.
[507] VN Review (2013), *http://vnreview.vn/goc-nhin-vnreview/-/view_content/content/781472/bong-ma-doc-quyen-dang-tro-lai-thi-truong-vien-thong-viet-nam*, 25 October.
[508] Tuoitre newspapers (2005), http://tuoitre.vn/Chinh-tri-Xa-hoi/86085/vu-ong-doc-quyen-vnpt-bi-to-cao--su-that-duoc-phoi-bay!.html, 30 June.
[509] Information Technology News (2013), http://www.tintuccongnghe.net/news/20-nam-di-dong-viet-nam-don-bay-nam-o-dau.ttcn, 24 August.

Viettel was the first network to provide strong competitive pricing policies by giving discounts of up to 75% of the service fee during peak hours, fixing GPRS charges at 80% of the existing price, and reducing charges on calls made from mobile to landlines in the Viettel network.[510] As a result, after only three years of market participation, Viettel had developed rapidly to become one of the three market leaders, together with Vinaphone and Mobifone.

3.5 *Taking advantage to secure market power*

In response to Viettel's attempts to enter the market, VNPT's network operators were forced to provide lower pricing and better service, which had positive results. Vietnam, which previously had one the most expensive telecoms pricing in the region, now maintained a comfortable telecoms market. Viettel's successful push and the removal of market entry barriers attracted other telecom service providers from both the private and public sectors to the market.

In 2010, the number of telecom service providers increased to 10 to include EVN Telecom, SPT, VTC Telecom, Viettel, VNPT, FPT Telecom, HTC, CMC (TI), Global Telecommunication Corporation (GTel), and Dong Duong.[511]

The two case studies below illustrate how Viettel had a competitive advantage in dealing with excess competition in the relevant market.

Excluding competitors from the telecom services market

Among the network operators is GTel, a small competitor established by the Ministry of Police in 2007 that operates in the telecoms and IT sector.[512] In 2008, it established GTel-Mobile, a joint venture with VimpelCom, the second largest mobile group in Russia, to provide telecom services under the Beeline brand. In April 2011, after three years of maintaining a low profile, VimpelCom announced that it would invest USD 500 million in Beeline by 2013, thereby bringing the total network investment to USD 1 billion and making Beeline the fourth major mobile network in Vietnam.[513] To realise this ambition, Beeline introduced a product called the *BigZero* package, which generated excitement among consumers and drove innovation in the market by reducing the price to marginal costs. At the time, Beeline's growth reached 400% per day and became a competitive threat to market leaders such as Viettel and VNPT.[514]

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[510] VN Review (2013), *http://vnreview.vn/goc-nhin-vnreview/-/view_content/content/781472/bong-ma-doc-quyen-dang-tro-lai-thi-truong-vien-thong-viet-nam*, 25 October.
[511] Information Technology Industry, Telecommunications, Posts And Broadcasting (2012).
[512] Gtel's offical website http://gtel.com.vn/.
[513] Itc News (2011), http://ictnews.vn/home/Vien-thong/5/VimpelCom-bom-them-von-vao-Beeline/77205/index.ict, 27 April.
[514] Itc News (2009), http://ictnews.vn/home/Vien-thong/5/Noi-am-anh-mang-ten-BigZero/19913/index.ict, 27 July.

Both VNPT and Viettel expressed fears that Beeline's practice of selling under market price was an unhealthy development in the market. This was provoked by Beeline launching bold campaigns that attracted large volumes of subscribers in a short time.

As a result, VNPT and Viettel publicly requested that the MIC secure the mobile network from cutthroat competition resulting from aggressive marketing activities. In particular, Viettel proposed that the MIC set the floor price at VND 800/minute for both 2010 and 2011.[515] The media expressed strong concerns that this proposal would cause great difficulties for small networks trying to enter the market. As the only route to survival for new entrants was through lower pricing, the application of a floor price essentially blocked them from competing with existing market leaders.

Despite the outcry, the government responded to Viettel's request by passing Decree No. 25/2011/ND-CP to detail and guide the implementation of some articles under the Law on Telecommunications. This decree provided restrictions on promotions and discounting, and assigned the MIC as the authority to set floor prices for telecom services.[516]

In addition, Beeline was also unable to apply 3G technology due to technical barriers created by the MIC and was forced to use the 1800 MHz band, which was more costly and less efficient than the 800-900 MHz band used by other operators.[517]

Beeline was thus unable to expand in the market due to market inefficiencies, such as low average revenue per user (ARPU), saturation level and the difficulty in expanding coverage. Finally, VimpelCom decided to sell its entire 49% stake in the joint venture to the local partner, GTel Mobile, in order to cut losses in 2012. According to published information, VimpelCom was paid USD 45 million in cash to completely pull out from the joint venture and GTel Mobile stopped using the Beeline brand after six months from the date of the transfer.

Following Decree No. 25/2011/ND-CP, the MIC issued Circular No. 14/2012/TT-BTTTT on 12 October 2012 to prescribe charge rates for terrestrial mobile communications services. This circular fixed the charge rates for such services and required network providers to comply with regulations on the management of telecom service charge rates issued by the MIC.[518] Circular No. 14/2012/TT-BTTTT also prohibited network operators from utilising low pricing schemes that may create unfair competition and cause market instability.[519]

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[515] VN Review (2013), *http://vnreview.vn/goc-nhin-vnreview/-/view_content/content/781472/bong-ma-doc-quyen-dang-tro-lai-thi-truong-vien-thong-viet-nam*, 25 October.
[516] Decree 25, Articles 36 and 39.
[517] Investment Review (2013), http://baodautu.vn/news/vn/doanh-nghiep/nhip-song-doanh-nghiep/vi-dau-beeline-nga-ngua.html, 26 August.
[518] Circular 14, Article 4.
[519] Circular 14, Article 5.

These regulations have effectively prevented other small network operators from applying low pricing strategies similar to Beeline in order to compete with VNPT and Viettel. As a result, S-Phone went bankrupt and EVN Telecom was forced to exit the market in 2012.

For the past seven years, the telecoms market in Vietnam has been dominated by Viettel and VNPT network operators, who operate a total market share of over 90%.

Monopolising the 3G service market

In 2011, following the restructuring of EVN, EVN Telecom, a subsidiary of EVN operating in the telecoms sector, was forced to liquidate due to consecutive losses. At the time, there were five 3G service providers: EVN Telecom, HTC, Vinaphone, VMS (Mobifone) and Viettel.[520]

Among them, HTC shared a license to exploit the 3G-frequency band with EVN Telecom and used EVN Telecom's 3G infrastructure. HTC applied for the government's approval to acquire EVN Telecom's 3G infrastructure upon its liquidation.

Viettel took the initiative to buy EVN Telecom in October 2011 to become the rival of HTC in the expected acquisition. It is worth noting that according to the Law on Competition, economic concentrations between competitors with an aggregate market share of more than 50% are prohibited except under certain conditions.

In view of this situation, HTC submitted a public letter to the VCA and the VCC, claiming that the merging of EVN Telecom with Viettel would lead to a violation of the Law on Competition.[521] The letter stated that:

i. Viettel already held a dominant position in the mobile market (allegedly 37% market share in the relevant market). The successful acquisition would grant it with power to potentially abuse its position,[522] thereby causing great harm to other competitors and customers.

ii. The combined market shares of Viettel and EVN Telecom would exceed 50% in the 3G service market, which is prohibited under regulations on economic concentration under the Law on Competition.[523] Therefore, this acquisition would contravene competition law unless it was established that an exemption applied, through demonstrating that EVN Telecom is facing bankruptcy or the acquisition would contribute to socio-economic development and technology advancement.[524]

[520] Information Technology Industry, Telecommunications, Posts And Broadcasting (2012), p. 49.
[521] Official Letter No. 585/CV-HTC dated 9 November 2011 from Hanoi Telecom on violation of Law on Competition in the transfer of EVN Telecom to Viettel.
[522] Vietnam, Law on Competition 2004, Article 13.
[523] Vietnam, Law on Competition 2004, Article 18.
[524] Vietnam, Law on Competition 2004, Article 19.

While the public letter was reported to have been received, no reply was received from the agencies.

On 5 December 2011, the Prime Minister signed Decision No. 2151/QD-TTg, which transferred EVN Telecom to Viettel, effective from 1 January 2012. Almost immediately after the acquisition of EVN Telecom, VNPT and Viettel sent separate notices to HTC indicating that the fee for hiring transmission channels would be increased by 276% and 207% from the previous fee, respectively.[525]

Despite both VNPT and Viettel denying claims of a conspiracy between them to ‘squeeze’ HTC’s margin, the fee increase due to competitive pressure from EVN Telecom was removed.

One year later on 16 October 2013, Viettel and VNPT simultaneously increased the current 3G service price by 40%. Although the price increase was endorsed by the MIC, the public raised legitimate concerns about it while also criticising the quality of 3G services.

As the network operators’ responses failed to quell public criticism, the Department of Telecommunications under the MIC defended Vietell and VNPT before the press.[526]
The defence was made, first, on the basis that the network operators had legally registered the new 3G service prices with the MIC before implementation. With approval from the MIC and for convenience in charging on a monthly basis, Viettel and VNPT applied the new prices on the same date of 16 October 2013, which is the second half of the month. Therefore, concerns about a price-fixing agreement can be cleared.

However, public concerns still existed as the official letters for registering the increase of 3G service prices of Viettel, Mobifone and Vinaphone were submitted within close proximity of each other (13 September 2013, 9 August 2013 and 5 September 2013, respectively). With a total market share of 90% and a simultaneous increase in service prices, it would be difficult for these market leaders to answer public concerns about a price-fixing agreement.

Moreover, it is argued that the 3G tariff proposals were approved quickly by the MIC. The approval was granted just one month after receiving the written requests from the major network operators. The MIC informed the press that the Department of Telecommunications had examined the reason for the price increase on the basis of service cost data provided by the three requestors. The Department did not carry out its own research to determine the rationality of the price increases. It treated the data provided by the requestors as the basis

[525] Ictnews (2012), http://ictnews.vn/home/Vien-thong/5/VNPT-Viettel-bi-to-bat-tay-tang-gia-cuoc-thue-kenh/103330/index.ict , 27 June.
[526] Dan tri (2013), http://dantri.com.vn/suc-manh-so/vafi-cuc-vien-thong-nhu-la-luat-su-bao-chua-cho-3-nha-mang-802842.htm, 14 November.

for the approval. These approvals caused great harm to the competitive environment and were not considered fair decisions for 3G users.

Accordingly, there still exists considerable public opinion that the three market leaders may have engaged in a price-fixing agreement, with the support of the Department of Telecommunications, to assist them to navigate through competition regulations.

The second basis of the defence was that the Department of Telecommunications had stated that the three networks were providing 3G services at 54% of the actual price. Therefore, they were eligible for a higher service price to maintain reasonable revenue figures. However, a preliminary examination by the Vietnam Association of Financial Investors (VAFI) revealed inconsistency in the Department's reasoning.

According to VAFI's research, a corporation selling its products at 60% of the actual price for several consecutive years will go bankrupt, operate at a loss or reduce its expenditures. However, the revenue, profit and income per capita of these three major network operators were constantly increasing due to their dominant positions. Additionally, while most of the domestic enterprises were applying slow depreciation regimes to reduce product prices, Viettel and VNPT had voluntarily applied a faster depreciation regime, which would have resulted in higher selling prices. Therefore, according to VAFI, the statement that the selling price was 54% of the actual price could not have been correct.

In brief, the contradictory explanation has put the Department of Telecommunications in an unfavourable light with the public, who believe that the decision favoured related SOEs at the expense of 3G users, including transportation companies.

Furthermore, VAFI also revealed additional evidence of the advantages that Viettel, Mobifone and Vinaphone had been given by the government. Particularly, despite owning 90% of the mobile network market share, the SOEs do not have to publicly declare information on their websites as required by international telecommunications practices.

It is clear that Viettel, Mobifone and Vinaphone, now enjoying more than 90% market share of the national mobile telecoms market, can effectively eliminate the competitiveness of the market if they cooperate. The chances of survival of the remaining two small networks, Vietnammobile and Gtel Mobile, are extremely small. This is particularly so as these networks will ultimately need to hire two transmission channels managed by VNPT and Viettel, both of which, based on previous behaviour, have a propensity to seek ways to increase charges and squeeze out other competitors by imposing trade and technical barriers. At the same time, the MIC's management and moderation appears to benefit larger networks provided by SOEs.

4. Conclusion

Apart from the basic net advantages to which Vietnamese SOEs have access, as discussed in section 2, the state is able to protect SOEs' positions in the market through other means such as state indemnification and policy-generated barriers. The case study of Viettel has illustrated such measures and hence the advantages that SOEs enjoy.

The case study further illustrates that SOEs, especially in the telecommunications sector, enjoy overt advantages granted by the state to gain market power and manipulate competition in the market. The role of competition law has been effectively eliminated by the active intervention of the government, particularly the MIC and other interested agencies. The case study also shows that the MIC's role in regulating disputes between enterprises in the telecommunications market is not impartial.

As a result, Viettel has gained a large market share after just a few years of operation while other foreign competitors such as SK Telecom and Vimpelcom were forced to withdraw from the market after several years of struggle in Vietnam, despite their superior financial capacity, technologies and experience elsewhere. Currently, Viettel has approximately 60 million mobile users (44% market share) and operates the strongest telecom network infrastructure of approximately 55,000 stations, including 25,000 3G stations. It is also reported that 3G services contribute over 50% of Viettel's total revenue.[527]

This would not have been achieved but for the preferential policies and administrative measures of the government agencies discussed above.

Recommendations for improvement

Vietnam is in the process of transitioning to a market economy, whereby the roles of SOEs are gradually reducing with the emergence of dynamic and efficient private sector enterprises. However, SOEs will play a critical role in the future of Vietnam's economy. The recently amended Constitution has indicated that state-owned sectors will continue to dominate the economy and SOEs will operate as the mainstay of public ownership in the marketplace to ensure the socialist orientation of the national economy.

Accordingly, the two biggest challenges that Vietnam's competition authorities have to overcome are political interference in the name of 'state economic management', and potential conflicts between competition policies and industrial policies that are usually exercised through the direct control of larger SOEs. In this context, a competitive neutrality policy is critical to enhancing the effectiveness of SOEs, as well as the efficient use of public resources.

[527] *Ibid*.

A strong commitment to market reform and trade liberalisation on the part of the Vietnamese government is critical for the success of adopting competitive neutrality principles in Vietnam. As discussed, this may only be achieved gradually and with the increasing recognition of the role of private sector enterprises in economic development. The process may be accelerated by external forces such as donors and international financial institutions, or through realisation of Vietnam's commitments to international and regional treaties. On 13 November 2010, Vietnam joined the ongoing Trans-Pacific Partnership (TPP) negotiations, demonstrating Vietnam's determination to further integrate into the global economy despite the TPP's requirements for a high degree of market transparency and openness. In addition, since the TPP strictly opposes discriminatory treatment between enterprises, the applicable advantages held by SOEs appear to be one of the biggest impasses in the TPP negotiations.

It is worth noting that the Law on Competition was enacted as a result of pressure on the country to join the World Trade Organisation. Although there remain unresolved issues in relation to enforcing indiscriminate policies between SOEs and private sector enterprises, the law successfully includes SOEs under the scope of its regulations despite opposition from conservative representatives. This should be regarded as the first critical milestone to adopting a competitive neutrality policy in Vietnam.

The following steps would probably be achieved during the TPP negotiations and implementation. In view of the Vietnamese landscape, a workable competitive neutrality policy must clarify the concept of 'state monopoly sectors' that are excluded from the scope of regulation of the Law on Competition. As discussed, SOEs usually employ regulatory loopholes to justify their conduct, which would otherwise violate the Law on Competition, by asserting that they are abiding by administrative orders. Therefore, a clear and concise definition of 'state monopoly sectors' will delineate the boundary of competition law and other administrative regulations.

The scope of state monopoly sectors may initially be wide enough to cover strategic industries, but will be gradually limited to those pursuing non-profit making activities such as providing public goods or services. The principles supporting competitive neutrality should be adopted for all SOEs outside state monopoly sectors and the competition authorities must be given absolute discretion in enforcing competition law in relation to these enterprises free from ministerial interference.

Currently, complaints against the government's decisions can be carried out through administrative proceedings at the courts. However, this often takes time and decisions are ineffective as courts rarely rule against the authorities' decisions unless they are manifestly wrong. As such, a complaints mechanism that allows interested parties to challenge government policies that lead to competitive advantages for SOEs should rely on independent arbitration or advocacy. In the context of Vietnam, the latter appears to be more efficient, given the weakness of the enforcement system.

Finally, the competition authorities can play a dynamic role in streamlining the process of adopting a competitive neutrality policy. Such a policy can never be achieved unless the competition authorities are powerful enough to, on one hand, advocate the policy and, on the other hand, take on large incumbent market players, especially big SOEs. Independence from political pressure is the only way to enable competition authorities to take on these SOEs. The VCA and the VCC thus need to be granted independent status from the government or, at least, equal status with other ministries. It is also necessary to remove institutional constraints that limit the power of the VCA and to allow the VCA to carry out its duties. For example, the VCA should be granted the power to enact guidelines and to grant exemptions, as well as to take responsibility for post-decision enforcement. Otherwise, the Vietnamese Law on Competition will be no more than a shield to protect SOEs from their private rivals.

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SOE Provisions in International Agreements

Graham Mott and Wan Khatina Nawawi

1. Introduction

In recent years, there has been growing concern in many developed countries about the national and cross-border activities of developing countries' state-owned enterprises (SOEs). Lack of transparency and the special relationship that such enterprises have with their governments have led to fears that foreign-based enterprises (notably, multinational corporations (MNCs) from developed countries) that operate in these countries are faced with a potentially unfair and uneven playing field. Cross-border investments in strategic sectors by these SOEs have also triggered national security concerns in developed countries, as evidenced by the investment bans set by the Australian and United States (US) governments against Huawei, a Chinese telecommunications company deemed to have strong support from the Chinese government.[528]

Governments, especially those in developed countries, began to take particular notice of SOEs' cross-border investment activities during the recent Global Financial Crisis of 2008-2009. During this period, SOEs from developing countries began to acquire many distressed assets in crisis-affected developed countries. Sovereign wealth funds (SWFs) were largely active in the banking and finance sector (acquiring assets in Barclays, Citigroup, Merrill Lynch and UBS AG) but other entities engaged across many sectors (such as the international expansion of Dubai Ports).[529] Indeed, partly as a result of the crisis, SWFs have now become important players in global financial markets, with approximately US$5 trillion in assets under management at the end of 2011. It is interesting to note that the resurgence of state capitalism is not confined to emerging or developing countries. The crisis also resulted in governments of developed countries undertaking extensive nationalisation, largely within their banking and automotive sectors, to provide state guarantees and subsidies for ailing firms.[530]

As suggested above, the establishment and maintenance of SOEs are not without problems and challenges. International concerns arise in view of the relationship and special connection

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[528] Australian Financial Review (AFR) (2012), 'Huawei ban puzzles Chinese businessmen', 28 March. See also US-China Economic and Security Review Commission Staff Report (2011), 'The National Security Implications of Investments and Products from the People's Republic of China in the Telecommunications Sector', 9-13.
[529] See Lee, Yvonne C.L. (2011), 'The Politics of Sovereign Wealth Funds: Benign Investors or Smoking Guns?', in Broude, Tomer, Marc L. Busch and Amelia Porges (eds) (2011), *The Politics of International Economic Law*, Cambridge University Press, p. 211.
[530] See Musacchio, Aldo and Francisco Flores-Macias (2009), 'The Return of State-Owned Enterprises: Should We be Afraid?', *Harvard International Review*.

that these entities have with their governments. This special connection is especially significant in periods of economic crisis, during which governments are politically motivated to give priority to these entities for government guarantees or financing. For instance, the Vietnamese government is providing lending support to its SOEs based on the proceeds made on a US$1 billion government bond issuance in January 2010.[531] The Chinese government is providing direct subsidies of US$8.1 billion to the Sinopec Corporation to cover the losses it made in 2008.

While some SOEs are established and subsequently regulated according to their respective national corporate laws, transparency issues still arise in many jurisdictions. For example, the Singapore Companies Act confers 'exempt private company' status on Temasek and other privately-held government-linked companies. This means that they do not have to make their balance sheet and profit and loss statements public, that they may lend money to their directors and companies, and that their directors are similarly exempted from disclosure requirements.[532]

Governments from developed countries are especially concerned that some SOEs' cross-border investments may not be based on commercial considerations, but rather may be politically motivated with the eventual goals of taking control of nationally strategic or sensitive assets. For example, the US has concerns regarding investments made by Chinese SOEs in the US aerospace technology and energy sectors, considered to be strategic industries by the US government.[533] Middle Eastern SWFs are viewed by some as being opaque, with questionable investment motives having been established by undemocratic governments (examples include the Libya Investment Authority, the Iran Oil Stabilisation Fund and the Oman State General Reserve Fund).[534]

Due to concerns such as these, the introduction and enforcement of the competitive neutrality principle in relation to SOEs has become a key issue in international law and trade negotiations. There have already been multilateral efforts to discipline SOEs through the various legal instruments of different international organisations, notably the World Trade Organization (WTO), the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF). Such efforts are now being complemented by the

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[531] See IMF (2010), 'Vietnam: 2010 Article IV Consultation—Staff Report and Public Information Notice', IMF Country Report No. 10/281, IMF, p. 21.

[532] See Shome, Anthony (2009), 'Singapore's State-Guided Entrepreneurship: A Model for Transitional Economies?', *New Zealand Journal of Asian Studies*, 11:1, pp. 318-336, p. 327.

[533] In 2011, the Aviation Industry Corporation of China (AVIC) acquired Cirrus Industries, Inc., while China Investment Corporation (CIC) acquired 15% equity shares in AES Corporation, a US power generating company. See Brightbill, Timothy C. (2012), 'Written Statement Before the US-China Economic and Security Review Commission', Hearing on Chinese State-Owned and State-Controlled Enterprises, pp. 3-4.

[534] See the SWF Linaburg-Maduell Transparency Index developed by the SWF Institute: http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/.

demands of developed countries, notably the US and the European Union (EU), to incorporate extensive SOE-related provisions into their preferential trade agreements (PTAs).[535]

This chapter addresses the issue of the international implementation of the competitive neutrality principle by exploring SOE-related provisions in international agreements, with a particular focus on the provisions incorporated into US PTAs. These were chosen as they tend to include more comprehensive SOE-related commitments compared to other PTA 'templates'. The chapter is divided into four further sections. The first of these discusses the various SOE-related disciplinary mechanisms at the multilateral level and identifies problems that arise from this multilateral approach. The second details the SOE-related provisions in existing PTAs. The third discusses how existing SOE-related provisions could potentially evolve, using the Trans Pacific Partnership Agreement (TPPA) as the basis for discussion. The final section offers some concluding remarks.

2. Disciplining SOEs through International and Multilateral Organisations

In view of the problems and challenges that could arise from the establishment and maintenance of SOEs, there have been attempts to discipline these entities at the multilateral level.

2.1 *SOE-related provisions in the WTO Agreements*

There is no specific WTO Agreement that regulates SOEs. Rather, SOE-related provisions are incorporated into various WTO Agreements, most notably the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS) and the General Agreement on Subsidies and Countervailing Measures (ASCM).

While there are various SOEs-related provisions in the WTO GATT, the key provision appears in Article XVII: State Trading Enterprises.[536] This can be discussed according to the following core elements:

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[535] For the purpose of this chapter, the term 'preferential trade agreements (PTAs)' will also refer to 'free trade agreements (FTAs)' and 'regional trade agreements (RTAs)'.

[536] Article XVII: State Trading Enterprises:

> 1. (a) Each contracting party undertakes that if it establishes or maintains a State enterprise, wherever located, or grants to any enterprise, formally or in effect, exclusive or special privileges, such enterprise shall, in its purchases or sales involving either imports or exports, act in a manner consistent with the general principles of **non-discriminatory treatment** prescribed in this Agreement for governmental measures affecting imports or exports by private traders.
>
> (b) The provisions of subparagraph (a) of this paragraph shall be understood to require that such enterprises shall, having due regard to the other provisions of this Agreement, make any such purchases or sales solely

1. **Scope and coverage**: GATT Article XVII has a narrow scope and coverage as it only regulates SOEs with trading function (STEs)[537] and not the entire spectrum of SOEs, which would also include production-based SOEs and SWFs.

2. **Disciplinary mechanisms**: WTO Members must ensure that their STEs operate in accordance to the non-discriminatory principle (Article XVII:1(a)) and on the basis of commercial consideration (Article XVII:1(b)). Members are also prohibited from preventing the STEs within their jurisdictions from acting in accordance with the previous two subparagraphs (Article XVII:1(c)). Furthermore, any importing activities must be carried out in a fair and equitable manner (Article XVII:2) and STEs must be mindful of the market access requirements already agreed upon by the Members (Article XVII:3).

3. **Transparency**: Article XVII:4 details the transparency requirements for STEs including the need for Members to provide timely and relevant information as regards STE operations.

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in accordance with **commercial considerations**, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales.

(c) No contracting party shall prevent any enterprise (whether or not an enterprise described in subparagraph (a) of this paragraph) under its jurisdiction from acting in accordance with the principles of subparagraphs (a) and (b) of this paragraph.

2. The provisions of paragraph 1 of this Article shall not apply to imports of products for immediate or ultimate consumption in governmental use and not otherwise for resale or use in the production of goods for sale. With respect to such imports, each contracting party shall accord to the trade of the other contracting parties' **fair and equitable treatment**.

3. The contracting parties recognize that enterprises of the kind described in paragraph 1 (a) of this Article might be operated so as to create serious obstacles to trade; thus negotiations on a reciprocal and mutually advantageous basis designed to **limit or reduce** such **obstacles** are of importance to the expansion of international trade.

4. (a) Contracting parties shall notify the CONTRACTING PARTIES of the products which are imported into or exported from their territories by enterprises of the kind described in paragraph 1 (a) of this Article.

(b) A contracting party establishing, maintaining or authorizing an import monopoly of a product, which is not the subject of a concession under Article II, shall, on the request of another contracting party having a substantial trade in the product concerned, inform the CONTRACTING PARTIES of the import mark-up on the product during a recent representative period, or, when it is not possible to do so, of the price charged on the resale of the product.

(c) The CONTRACTING PARTIES may, at the request of a contracting party which has reason to believe that its interest under this Agreement are being adversely affected by the operations of an enterprise of the kind described in paragraph 1 (a), request the contracting party establishing, maintaining or authorizing such enterprise to **supply information** about its operations related to the carrying out of the provisions of this Agreement.

(d) The provisions of this paragraph shall not require any contracting party to disclose confidential information which would impede law enforcement or otherwise be contrary to the public interest or would prejudice the legitimate commercial interests of particular enterprises.

Reproduced from the WTO GATT webpage: http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm.

[537] Different types of STEs include: Export Marketing Boards, Fiscal Monopolies, Canalizing Agencies and Foreign Trade Enterprises. For more details, see the section on Technical Information on State Trading Enterprises on the WTO website: http://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm.

The two relevant SOE-related articles in the WTO GATS are Article VIII: Monopolies and Exclusive Service Suppliers and Article IX: Business Practices.[538] Again, these articles are examined by looking at their core elements:

1. **Scope and coverage:** The WTO GATS takes a broader approach to addressing the activities of monopolies and exclusive service suppliers, which include both privately and publicly owned service suppliers.

2. **Disciplinary mechanisms:** Article VIII:1 provides for the application of the non-discriminatory principle (most-favoured nation), while Article VIII:2 aims to ensure that such enterprises do not abuse their monopoly position. Article IX aims to regulate the business practices of service suppliers to ensure that they do not behave anti-competitively.

3. **Transparency:** Articles VIII:3 and VIII:4 aim to provide transparency on these enterprises' operations as well as a notification requirement to the WTO.

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[538] Article VIII: Monopolies and Exclusive Service Suppliers:

1. Each Member shall ensure that any monopoly supplier of a service in its territory does not, in the supply of the monopoly service in the relevant market, act in a manner inconsistent with that Member's obligations under Article II and specific commitments.
2. Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments.
3. The Council for Trade in Services may, at the request of a Member which has a reason to believe that a monopoly supplier of a service of any other Member is acting in a manner inconsistent with paragraph 1 or 2, request the Member establishing, maintaining or authorizing such supplier to provide specific information concerning the relevant operations.
4. If, after the date of entry into force of the WTO Agreement, a Member grants monopoly rights regarding the supply of a service covered by its specific commitments, that Member shall notify the Council for Trade in Services no later than three months before the intended implementation of the grant of monopoly rights and the provisions of paragraphs 2, 3 and 4 of Article XXI shall apply.
5. The provisions of this Article shall also apply to cases of exclusive service suppliers, where a Member, formally or in effect, (a) authorizes or establishes a small number of service suppliers and (b) substantially prevents competition among those suppliers in its territory.

Article IX: Business Practices:

1. Members recognize that certain business practices of service suppliers, other than those falling under Article VIII, may restrain competition and thereby restrict trade in services.
2. Each Member shall, at the request of any other Member, enter into consultations with a view to eliminating practices referred to in paragraph 1. The Member addressed shall accord full and sympathetic consideration to such a request and shall cooperate through the supply of publicly available non-confidential information of relevance to the matter in question. The Member addressed shall also provide other information available to the requesting Member, subject to its domestic law and to the conclusion of satisfactory agreement concerning the safeguarding of its confidentiality by the requesting Member.

Reproduced from the WTO GATS webpage: http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm.

The WTO ASCM regulates subsidies on trade in goods in general with no specific regulation or prohibition on subsidies provided to SOEs. However, the principles of the agreement may be applicable:

1. **Scope and coverage:** The ASCM complements Articles VI and XVI of the WTO GATT and provides a disciplinary framework for subsidies. Many types of preferential financial assistance extended to SOEs may be defined as subsidies and therefore made subject to the provisions of the ASCM. Further, as SOEs are categorised as public bodies by Article 1.1(a)(1) of the ASCM, any given subsidies may fall under the provisions of the Agreement.

2. **Disciplinary mechanisms:** Article 3 of Part II: Prohibited Subsidies in the ASCM prohibits export subsidies and subsidies contingent on the use of domestic goods. Article 7 outlines the remedies for injured WTO Members suffering from the adverse effects of actionable subsidies implemented by other WTO Members, which include removal or withdrawal of the subsidies. Article 27 of Part VIII: Developing Country Members in the ASCM provides special and differential treatment of developing country Members, exempting privatisation-related subsidies from the provisions of Part III: Actionable Subsidies in the agreement.

3. **Transparency:** Article 25 of Part VII: Notification and Surveillance of the ASCM requires the WTO Members to notify of any imposed subsidy, as per Article 1:1. Difficulties with enforcement may occur if there is not a clear separation between the corporate and national financial accounts.

Disciplinary measures as part of WTO accession commitments

During the process of accession, the WTO may require further commitments or agreements from its new Members, other than those that the new member would be subject to automatically. In the case of China's accession, which occurred in December 2001, its SOEs were subject to a number of additional regulations.

The WTO Report of the Working Party on the Accession of China [539] extends the provisions relating to STEs in GATT Article XVII, as outlined above, to cover all types of SOE in China and to prohibit the Chinese government from influencing, directly or indirectly, commercial decisions undertaken by its SOEs. Further, China agreed, under the Protocol on the Accession of the People's Republic of China, not to seek special dispensation for the use of domestic subsidies, as extended to developing country Members by Article 27 of the ASCM, or to maintain export or agricultural product subsidies.[540] The Protocol also outlines non-market

[539] See WTO Report of the Working Party on the Accession of China, paragraph 46, WT/ACC/CHN/49.
[540] See WTO Protocol on the Accession of the People's Republic of China, sections 10.3 and 12.1, WT/L/432.

economy methodologies and benchmarks that may be used to quantify the levels of Chinese subsidies in disputed cases.

While it may be very difficult, or indeed impossible, to extend new disciplinary mechanisms regarding SOEs across existing memberships of multilateral organisations, accession agreements may be used, as above, to reinforce existing mechanisms or introduce new commitments that fill in the inherent gaps in the existing regulations and their intended outcomes.

2.2 *The OECD guidelines on corporate governance of state-owned enterprises*

The OECD, working together with the IMF and World Bank, has developed a set of guidelines and best practices on corporate governance of SOEs. Unlike the WTO Agreements which are legally binding for WTO Members, the OECD guidelines are non-binding and voluntary. They work more towards improving the performance of SOEs than disciplining them per se. In particular, the guidelines recognise six key principles:[541]

1. States need to develop effective legal and regulatory frameworks for SOEs.

2. States need to enforce the legal and regulatory framework in a transparent and accountable manner.

3. States need to provide equitable treatment to all SOEs' shareholders and equal access to information.

4. SOEs need to report the nature of their relations with stakeholders.

5. SOEs need to maintain high level of transparency and disclosure standards.

6. SOEs need to ensure their boards act with integrity and competency.

These guidelines also outline several practices for corporate accounting standards[542] that address the issues of identification and transparency with the ASCM, as highlighted above.

It is interesting to note that the current OECD guidelines are largely based on the organisation's previous work on the proposed multilateral agreement on investment (MAI)

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[541] See OECD (2005), 'OECD Guidelines on Corporate Governance of State-Owned Enterprises', Organisation for Economic Co-operation and Development, pp. 12-18.
[542] Chapter V, Section D.

launched soon after the establishment of the WTO in 1995.[543] While the MAI negotiations failed, the agreement's legacy can be seen in the SOE-related provisions incorporated into US PTAs. Indeed these provisions closely resemble the articles included in the MAI draft text.[544]

2.3 *The 'Santiago Principles' for Sovereign Wealth Funds (SWFs)*

Developed countries such as Australia and the US have attempted to regulate SWFs' investments unilaterally through their respective foreign investment laws. However, they recognise that this approach may not be adequate in addressing their key concern, namely a lack of transparency about SWFs' objectives and operations. They further recognise that a more holistic approach involving SWFs and other host countries should be adopted, in order to ensure consistency in regulatory outcomes.

The work to regulate SWFs has been led by the International Working Group of Sovereign Wealth Funds (IWG), coordinated by the International Monetary and Financial Committee (IMFC), a committee of the IMF Board of Governors.

In 2008, the IMFC announced a set of Generally Accepted Principles and Practices (GAPP) for SWFs, also known as the 'Santiago Principles'. There are 24 principles covering three main areas: legal frameworks, institutional frameworks and investment and risk management frameworks. Like the OECD guidelines, the Santiago Principles are non-binding for IWG members, which currently consist of 26 IMF Member countries. Also, as with the OECD guidelines, the focus of the Santiago Principles is on providing greater transparency and accountability of SWFs in the three areas just mentioned.

2.4 *Problems with existing multilateral SOE-related frameworks*

Despite the wide range of provisions that exist to address SOEs, three main areas of oversight remain.

First, with the exception of the OECD guidelines, the mechanisms discussed above consist of measures that address specific types of SOEs: STEs in the case of the WTO GATT and SWFs in the case of the Santiago Principles. This narrow scope could be due to the specific mandate of these international organisations, namely that the IWG chiefly addresses SWFs or certain SOEs whose investment functions may impact global financial markets.

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[543] See details available in the Multilateral Agreement on Investment section on the OECD website at: http://www.oecd.org/document/35/0,3343,en_2649_33783766_1894819_1_1_1_1,00.html.

[544] See OECD (1996), 'Draft Article on Monopolies/State Enterprises', DAFFE/MAI/EG3(96)19, Expert Group No. 3 on 'Special Topics', Negotiating Group on the Multilateral Agreement on Investment (MAI), Organisation for Economic Co-operation and Development, pp. 2-3.

Second, some provisions are not evolving to address the increasing scope and complexity of the functions of SOEs. For example, WTO GATT Article XVII solely concerns the trading functions of SOEs, and neglects the effects that production functions can have on international trade. Similarly, WTO GATS Article VIII was drafted when infrastructure, utilities and telecommunications services were mainly provided by government-owned monopolies or exclusive service suppliers. Technological progress and the introduction of competition have subsequently limited the relevance of Article VIII.

Third, the majority of international and multilateral organisations fail to require strong commitments from members to discipline their own SOEs, with both the OECD guidelines and the Santiago Principles being non-binding and voluntary. Further, the WTO Agreements mostly focus on improving the structural, functional and behavioural transparency of SOEs by requiring notification of relevant details by Members. However, this requirement has not been widely adhered to; rather WTO Members have sought to take advantage of the exclusions set out in the Agreements.[545] Additionally, WTO Members have expressed uncertainty about the definition of state trading enterprises, and the scope of the relevant articles.[546]

3. SOE-related Provisions in Existing PTAs

Developed countries, particularly the US and the EU, have attempted to address the gaps identified in current SOE disciplinary mechanisms at the multilateral level by incorporating SOE-related provisions into their PTAs. This section discusses a number of PTAs, with particular focus on SOE-related provisions in US PTAs, as these often require expansive commitments from PTA partners.

SOE-related provisions in PTAs will be examined in relation to five elements: 1) scope and coverage; 2) disciplinary mechanisms; 3) transparency of existence; 4) transparency of behaviour; and 5) dispute settlement.

3.1. *Scope and coverage*

SOE-related provisions have been incorporated into various chapters of the PTAs, most notably the chapters on Investment, Cross-border Trade in Services (CBTS), Government Procurement (GP) and Competition. The main objective of these provisions is to clarify the

[545] Indeed the Chairman of the Working Party on State Trading Enterprises expressed his concerns over the poor compliance by Members in notifying the WTO of their state trading activities. For instance, only 12 Members provided updated notifications in 2003, while only 48 Members provided new and full notifications in 2001. See WTO (2003), Report of the Working Party on State Trading Enterprises, G/STR/W/41, p. 2.
[546] See GAO (1995), 'State Trading Enterprises: Compliance with the General Agreement on Tariffs and Trade', GAO/GGD-95-208, Report to Congressional Requesters, United States General Accounting Office, pp. 9-10.

scope and coverage of these chapters, thus providing certainty for the parties when interpreting their commitments in the PTAs.

The articles on scope and coverage in the Investment Chapters of the US PTAs with the Dominican Republic and Central America, Oman, Peru, Colombia and Panama explicitly acknowledge that the commitments in the chapter apply to SOEs not just when performing their investment function, but also when exercising 'any regulatory, administrative, or other governmental authority' delegated to them by the parties. Under some PTAs[547], subsidies or grants provided by SOEs are excluded from the application of non-discriminatory principles (national treatment and most-favoured nation), performance requirements and the senior management and board of directors' provisions in the Investment Chapter.

It is important to look at the scope and coverage of the Investment Chapters in light of the comprehensive dispute settlement mechanism (DSM) and investor-state dispute settlement (ISDS) procedures they also set out.

The articles on scope and coverage in the CBTS Chapters of PTAs often provide exclusion for 'subsidies or grants provided by a Party or a state enterprise'[548]. Readers need to be careful when reading the article on the scope and coverage of a chapter; this must be looked at concurrently with the commitments made in other chapters. For instance, while a chapter may exclude SOE-related disciplinary mechanisms, these may be covered in other chapters and so be subject to the DSM provisions.

The Government Procurement (GP) Chapters often provide exclusion for 'non-contractual agreements or any form of assistance' provided by such enterprises or 'procurements made by an entity or state enterprise from another entity or state enterprise of that Party'. Interestingly, the GP Chapter in the Oman-US FTA also includes a side letter on SOEs to clarify that the Omani government shall:

> not exercise any undue control or influence in procurement conducted by Omantel, Petroleum Development Oman, and Oman Liquefied Natural Gas. The Sultanate of Oman shall ensure that all procurement by these entities is conducted in a transparent and commercial manner.

This acknowledges the various forms of SOEs, including those with a production function as well as the STEs, that is SOEs with a trading function, covered in GATT Article XVII.

[547] For example, NAFTA, Canada-Chile FTA (Article G-08), Australia-Chile FTA (Article 9.2, 3(c)).
[548] For example, Canada-Chile FTA (Article H-01, 2(d)), Canada-Honduras FTA (Article 11.2, 2(d)).

Many PTAs[549] include specific Competition Chapters, of which a large majority include some form of SOE-related provisions. These Competition Chapters also include definitions of ‘state enterprise’ (e.g. the Australia-US FTA), ‘Crown corporation’ (e.g. the Canada-Jordan FTA), ‘government monopoly’ (e.g. the US-Chile FTA), ‘effective influence’ (e.g. the US-Singapore FTA) and ‘in accordance with commercial considerations’ (e.g. the US-Colombia FTA). These definitions are important in clarifying the types of SOEs that are covered by the chapters.

Further, within the Competition Chapter of the Korea-Singapore PTA, Article 15.4 goes so far as to set competitive neutrality as an objective, stating that:

1. Each Party shall take reasonable measures to ensure that its government does not provide any competitive advantage to any government-owned businesses in their business activities simply because they are government-owned.
2. This Article applies to the business activities of government-owned businesses and not to their non-business and non-commercial activities.

A number of other PTAs include similar clauses.[550]

Additionally, the SOE-related provisions in the Competition Chapters for both the North American FTA (NAFTA) and the US-Singapore FTA (USSFTA) are not applicable to government procurement (see Article 1502.4 and Article 12.3.4 respectively). This has changed in the later US PTAs, perhaps in recognition of the fact that SOEs engaged in government procurement activities could behave anti-competitively (through bid-rigging in the tendering process, for instance) and so should be covered by the SOE-relevant commitments in the chapter.

3.2 *Disciplinary mechanisms*

All the designated monopolies-related provisions in the Competition Chapters of the PTAs surveyed incorporate three key disciplinary elements from the WTO Agreements:

1. SOEs must adhere to the non-discriminatory principle for commercial activities, i.e. in their purchase or sale of goods or services.

2. SOEs must act solely in accordance with commercial considerations in their purchase or sale of goods or services.

3. SOEs must not engage in anti-competitive conduct or abuse their monopoly positions.

[549] See for example: US PTAs (NAFTA, Singapore, Australia, Peru, Colombia and South Korea), Korean PTAs (EU, Singapore, Chile), Australia PTAs (Singapore, Chile), Japan PTAs (India).
[550] See for example: Australia-Singapore FTA (Chapter 12, Article 4).

The first two elements are consistent with the disciplinary elements in GATT Article XVII, while the third element is consistent with GATS Article IX on Business Practices. There is also the additional element of prohibition on acting inconsistently with the Party's obligations when such enterprises are exercising 'regulatory, administrative or other delegated governmental authority'. This recognises the fact that SOEs can have multiple roles and responsibilities which may not be consistent with each other.

In PTAs that include specific chapters on competition, there are typically explicit clauses ensuring that signatories are not prevented from maintaining or establishing SOEs or from designating monopolies, thus respecting partners' sovereign rights.[551] However, it is interesting to observe that the US departed from this position to effectively restrict the rights of its partners in the USSFTA and Korea-US (KORUS) FTA:

1. **The USSFTA**: Article 12.3.2(f) requires Singapore to reduce and eventually eliminate its ownership of government-linked companies (GLCs).

2. **The KORUS FTA**: The article on designated monopolies requires Parties to ensure their designated monopolies adhere to the disciplinary elements, with no explicit mention of not preventing them from designating monopolies in their jurisdictions. This follows the language found in both GATT Article XVII.1(a) and GATS Article VIII.1 that the sovereign rights of the Members to designate monopolies or to maintain or establish state enterprises are protected so long as the conduct of such entities is consistent with Members' obligations.

Other PTAs only go so far as to apply competition law to signatories' SOEs such that the application of this law does not infringe or endanger the stated objectives of the SOEs. For example, the Chile-Korea FTA (Article 14.8.2) and the EU-Chile Associated Agreement (Article 179, 2) both contain similar language to the EU-Korea FTA (Article 11.4, 1):

1. With respect to public enterprises and enterprises entrusted with special rights or exclusive rights:

   (a) neither Party shall adopt or maintain any measure contrary to the principles contained in Article 11.1; and

[551] For example, in the Canada-Chile FTA, there are two such explicit provisions in both the articles on designated monopolies and state enterprises:

1. 'Nothing in this Agreement shall be construed to prevent a Party from designating a monopoly.' (Article J-02.1) and,
2. 'Nothing in this Agreement shall be construed to prevent a Party from maintaining or establishing a state enterprise.' (Article J-03.1).

(b) the Parties shall ensure that such enterprises are subject to the competition laws set out in Article 11.2,

in so far as the application of these principles and competition laws does not obstruct the performance, in law or in fact, of the particular tasks assigned to them.

3.3 *Transparency of existence*

The SOE-related provisions in the Competition Chapters of PTAs generally provide for the transparency of existence of such enterprises.

The approach under NAFTA was to require parties to, '**wherever possible**, provide **prior** written notification to the other Party of the designation' (Article 1502.2(a), emphasis added). This was incorporated into the main article on monopolies and state enterprises. This is similar to the approach taken by GATS Article VIII.4 which also required such notification to be provided three months before implementation. The NAFTA requirement seems to be on a 'best endeavour' basis in view of the phrase 'wherever possible', an approach that has been replicated in other PTAs.

The USSFTA incorporated more details of the types of information that the Singapore government should make available (see Article 12.3.2(g)). Again, this is in view of the fact that SOEs are protected from having their financial details made public by the domestic Companies Act.

In subsequent US PTAs, the notification requirement was simplified and moved to its own separate article on 'Transparency' or 'Transparency and Information Requests'. While the PTA Parties do not need to provide prior notification, the transparency requirement is no longer on a 'best endeavour' basis. The requirement is further clarified to include 'any level of government', recognising the fact that such entities could be designated or maintained and established by sub-federal level government.

3.4 *Transparency of behaviour*

The transparency articles in many of the Competition Chapters also require notification of 'practices that may **hinder trade or investment between the Parties**' (emphasis added). [552] This seems to imply that any practices that only adversely affect the domestic market need

[552] See for example: EU–Chile Associated Agreement (Article 179.2).

not be notified. Parties may need to refer to the 'relevant market' test which is used in competition law.

Many PTAs contain clauses that ensure SOEs cannot escape censure by the governmental delegating authority. For example, the Peru-Canada FTA, Article 1306, 2 states that:[553]

> Each Party shall ensure, that any state enterprise that it establishes or maintains, acts in a manner that is not inconsistent with the Party's obligations under Chapters Eight (Investment) and Eleven (Financial Services) wherever such enterprise exercises any regulatory, administrative, or other governmental authority that the Party has delegated to it, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees, or other charges.

3.5 *Application of dispute settlement*

All the SOE-related provisions in the Competition Chapters of the surveyed PTAs are not excluded from the general dispute settlement provisions. The SOE-related provisions in the Investment Chapters could be subject to the ISDS mechanism incorporated in those chapters, as highlighted earlier.

4. SOE-related Provisions in Future Agreements

The previous section highlighted the evolution of SOE-related provisions in US PTAs and the provisions in a number of non US PTAs. The following section discusses the most recent development in the multilateral regulatory framework for SOEs, the Trans-Pacific Partnership, and outlines recent changes to the US Model Bilateral Investment Treaty. While it is difficult to make firm suggestions about the content of any possible future agreements, a number of key issues are outlined below.

4.1 *SOE-related provisions in the US Model Bilateral Investment Treaty 2012*

Whilst the previous 2004 Model Bilateral Investment Treaty (BIT) already addressed the issue of SOEs,[554] the most recent 2012 Model BIT[555] responded to the interim evolution in the

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[553] See also: Australia-US FTA (AUSFTA) (Article 14.4, 1(a)), Canada-Chile FTA (Article J-03.2), KORUS FTA (Article 16.3, 1(a)).

[554] See Article 2, section 2:

> A Party's obligations under Section A shall apply: (a) to a state enterprise or other person when it exercises any regulatory, administrative, or other governmental authority delegated to it by that Party;

http://www.state.gov/documents/organization/117601.pdf.

[555] http://www.state.gov/documents/organization/188371.pdf.

actions and functions of SOEs by including three additional disciplinary mechanisms. First, Article 8: Performance Requirements prevents parties from imposing domestic technology requirements. This includes requiring preference for domestically developed technology in order to provide an advantage to a party's own investors, investments or technology. Second, Article 8 allows investors from the other party to participate, on non-discriminatory terms, in the development of standards and technical regulations, and further recommends that non-governmental standards bodies observe this requirement. Third, footnote 8 of Article 2: Scope and Coverage in the 2012 Model BIT outlines the conditions that determine if governmental authority has been delegated to an SOE, to ensure that such enterprises are compliant with and covered by the obligations of the BIT.

4.2 *SOE-related provisions in the Trans-Pacific Partnership Agreement*

Background to the TPPA negotiations[556]

The TPPA is, in effect, a proposal for the expansion of the Trans-Pacific Strategic Economic Partnership Agreement (P4 FTA). This original free trade agreement was signed in June 2005 by Brunei, Chile, New Zealand and Singapore, and contained a clause for the accession of other countries, to be encouraged by existing members. Presently, a number of countries have agreed to join the negotiating process for membership to the TPP: the United States, Australia, Peru, Vietnam (all in 2008), Malaysia (in 2010), Mexico, Canada (both in 2012) and Japan (in 2013). At the time of writing, negotiations have been ongoing for nineteen rounds.

Incorporating an updated definition of SOEs

As outlined earlier, SOEs have evolved significantly over the last two decades and have become internationally proactive and expansive. They have taken on a larger variety of functions and compete in a wider range of sectors and commercial markets. Due to this rapid evolution, it is perhaps no longer sufficient to define SOEs along the 'traditional' lines of ownership, control or effective influence, as was done in previous PTAs. The TPPA should define SOEs in a manner that reflects these 'new' characteristics, with differing sections of the agreement addressing specific functions and roles. Finally, it is important that however SOEs are defined, the definition is applied consistently across the whole of the agreement, ensuring that regulations can be applied to a given SOE in its entirety, not just to its constituent parts.

Incorporating stronger transparency provisions

Within most existing PTAs, transparency provisions are insufficient and do not effectively promote compliance with requests for information or disclosure.

[556] See details on the TPPA section of the USTR website at: http://www.ustr.gov/tpp.

There may be demands for future transparency provisions to incorporate details about the process for notification and information requests, including specific timelines for responses,[557] contact or reference points for stakeholders, language requirements, types of information requested, [558] and feedback or redress mechanisms to address violations.

Committing SOEs to abide by national laws and regulations

There are concerns that, unlike private enterprises, SOEs could be given outright exclusion or exemption from other national laws and regulations, including competition or antitrust laws, without having to prove the fulfilment of requirements relieving them of liabilities.[559]

As a result, there may be demands for members to commit to a disciplinary mechanism that limits or minimises certain loopholes, as identified in the USSFTA, that often result in SOEs being given outright exemption or exclusion from their national laws and regulations. As part of the article on transparency and information requests, signatories could also be requested to provide relevant information on how such national laws would be applied to SOEs and, if applicable, how exclusion or exemption requirements had been assessed.

Recognising the importance of SOEs' contribution to national economic development

One of the most commonly-cited objectives for the establishment and continued existence of SOEs is to assist in the enforcement of economic development policies that fulfil aims not (readily) addressed by private commercial activities. This approach is used in almost all of the negotiating countries, some to a larger degree than others. For example, all Vietnamese telecommunications are state-run and SOEs account for roughly 40% of output (Economist Intelligence Unit, *Vietnam Country Report*, March 2012, p. 12); Japan Post is one of the world's largest banks and insurers; Singapore and Malaysia have significant SOEs; New Zealand has extensive SOE sectors in many parts of its economy including KiwiBank, KiwiRail and Air New Zealand.[560]

Some of these TPPA Members could call for the incorporation of SOE-related provisions which acknowledge the link between state capitalism and national economic development, as recognised in P4 FTA Article 9.2.3:

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[557] For example, GATS Article VIII.4 specifies the timeline for Parties to respond.

[558] For example, Article 12.3.2(g) in the USSFTA provides the best example so far of the disclosure details required from Singapore.

[559] For example, the Malaysian Competition Act 2010 allows for enterprises to seek 'relief from liability' from the application of the prohibitions on anti-competitive agreements (Chapter 1) provided that they are able to meet all the four requirements outlined in the section. The Singapore Competition Act 2004 excludes many government-linked companies (GLCs) from its application. China also indirectly exempts its SOEs from its Anti-Monopoly Law if they operate in industries that are 'critical to the wellbeing of the national economy and national security'. This compares to the situation in Malaysia whereby its new Competition Act 2010 applies to all commercial activities, including those undertaken by the GLCs and similar entities.

[560] Radio New Zealand (2011), 'Trade talks target state support for businesses', 6 September: http://www.radionz.co.nz/news/national/84427/trade-talks-target-state-support-for-businesses#pdl.

> Competition law shall apply to all commercial activities. However, each Party may exempt specific measures or sectors from the application of their general competition law, provided that such exemptions are transparent and undertaken on the grounds of **public policy** or **public interest**.

However, the incorporation of such an article may lead to a number of arguments concerning the scope of the two terms in bold. Definitions of the actions that fall under the remit of public policy or public interest will vary greatly across jurisdictions and it may be that specific mechanisms will need to be put in place to monitor or regulate the enactment of such an article. Further, developing TPPA Members may also seek a cooperation-type commitment, asking developed Members to offer capacity-building and technical assistance on the governance and reform of existing SOEs. However, they may be referred to both the OECD guidelines and Santiago Principles as references to ensure a level playing field amongst all TPPA Members, in terms of governance best practices and transparency requirements. For instance, Malaysia, Peru, Singapore and Vietnam are not OECD Members while Brunei and Vietnam are not signatories to the Santiago Principles. Developing TPPA Members need to be aware of these high quality best practice provisions and should ensure that their relevant regulatory institutions could implement such commitments.

Building an emergency safeguard mechanism to address crises

As outlined in the introduction of this chapter, during the Global Financial Crisis of 2008-2009 governments from both developing and developed countries chose to provide support for troubled firms and in some cases, undertook a process of nationalisation. This may generate a number of concerns including the possible perception of expropriation, access and priority of support in terms of foreign and domestic firms, and possible violations of existing non-discriminatory principles.

The complexity of individual situations may be addressed in the context of the TPPA, where signatories may wish to develop emergency safeguard mechanisms as part of the provisions. The mechanisms could address issues such as assistance targeting, support efficiency, minimizing market distortions, transparency and support withdrawal. These would provide governments with the flexibility to implement appropriate policies in times of crisis, without contravening a rigid system of regulation pertaining to state capitalism.

Ensuring consistency of scope and coverage for SOEs across TPPA chapters

As mentioned earlier, members will need to ensure consistency of scope and coverage for SOEs across all the TPPA chapters.

The TPPA as a framework for the future

There is a distinct possibility that a realised TPPA would set the framework and become a template PTA, to be replicated in other PTAs. As a result, for the US, establishing a set of clearly defined regulations to enforce the principles of competitive neutrality within the framework of the TPPA and among members is vital. As new members join in the future, they commit their SOEs to abide by the regulations contained within the agreement. Both China and Russia are APEC members and are feasible future signatories with high numbers of economically powerful SOEs. Even if these countries do not apply for membership, the TPP Agreement will represent a platform of international agreed norms for members to require non-signatories to recognise and to which they should align.

Further, it is important to note that some of the TPP Members already had PTAs with each other, particularly the US. There must be a provision within the agreement that acknowledges previous PTAs and the application of agreed commitments. Indeed, all provisions agreed within the TPP framework must supersede Members' previous PTA commitments in order to create a strong multilateral platform and to minimise treaty shopping.

5. Conclusions

As the champions of the liberal market economy come to terms with the resurgence of state capitalism and the emergence of SOEs as important actors on the international stage, we expect the issues and challenges associated with SOEs to receive more attention than ever. As a result, greater emphasis will be placed upon the ability of the international legal framework to discipline SOEs and enforce the principles associated with competitive neutrality.

As this chapter has shown, there are a large number of agreements, both bilateral and multilateral, that attempt to address the market behaviour of SOEs. However, in many cases, these agreements have not evolved at the same rate as the characteristics and functions of SOEs. Understandably, this is particularly true of multilateral agreements, which are often slow to amend and adapt due to the need to find consensus amongst a large number of member and signatories. Currently, the multilateral agreements outlined above form a patchwork, only addressing some types of SOE or some areas in which they function. Bilateral agreements have been quicker to address the SOE issue. It has been shown how, in particular, the US-based PTAs have evolved in order to take into account some of the pertinent issues. Indeed it seems there has been a drive in the recently negotiated US and EU PTAs to include wider SOE disciplinary mechanisms, such that these may form a platform of international norms on which to base future multilateral agreements.

In terms of SOE discipline, the proposed TPP Agreement is the most important currently under negotiation. Many TPPA Members will challenge stronger and deeper levels of SOE-related commitments in the TPPA, as they would result in the potential dismantling of current business practices in their economies. With the addition of Mexico, Canada and Japan to the negotiations in the last twelve months, the voice of this cohort looks to have been considerably strengthened. The issues outlined in the preceding section affirm the need for TPP Members, the US especially, to find a balance between stronger and development-based SOE-related commitments. In the future, it is possible that the mandated growth of TPP Members will expand to include China and Russia. As such it is all the more important for the US and the rest of the TPP Members to agree to a balanced and high quality SOE-related commitment at this first stage of what may eventually turn out to be an APEC-wide PTA.

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