The Agendas of State-Owned Enterprises Raise Foreign Policy, Not Just Domestic, Concerns

by Andrew Davenport

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POLICY UPDATE

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Over the past several years, federal governments have increasingly been compelled to make a distinction between the investments and business transactions of state-owned enterprises (SOEs) occurring within their countries and those of private sector entities pursuing strictly commercial agendas.

Canada encountered this issue in the case of Nexen's acquisition by China National Offshore Oil Corporation (CNOOC). Australia is grappling with this issue in the context of their recently signed free trade agreement with China. In a more combustible environment, European states have likewise had to face the reality that these companies present unique – even strategic – risks, having apparently successfully moved Russia, and state-owned Gazprom, off of its plans to build and own the South Stream pipeline, which would have circumvented Ukraine in order to provide natural gas exports directly to European customers. This trend is likely to continue, as China's major state-owned – and state-controlled – entities continue to emerge as viable alternatives to their multinational competitors in areas like energy, metals and mining and telecommunications and as Russia continues to lean on its SOEs as highly useful extensions of the state's overall power projection capabilities.

As a consequence, new norms are developing concerning this category of business and how authorities ought to review and vet such investments for potential economic and security concerns within their borders. These norms, however, are presently too narrow. The global business agendas of SOEs raise concerns that go beyond the defence of critical infrastructure and the protection of domestic industries and economic assets.

The reality is that the growing global footprint of state-owned enterprises, their use as strategic arms of the state and the function they serve in the projection of soft power abroad is a foreign policy and national security issue regardless of whether or not these transactions are occurring within national borders. They represent a growing phenomenon in the way influence is garnered.

The same concerns held by federal governments about the strategic implications of giving up their own critical assets and infrastructure to foreign SOEs are also applicable for other countries in which these companies operate. Often, these are countries that are less equipped than more developed economies to turn down the significant capital, resources, low-cost financing, favourable pricing and other corollary benefits that these companies offer to sweeten their business proposals and bids. The risks and policy concerns presented by these deals should be relevant to Western governments that have an interest in the stability and security of countries around the world where this is occurring.

Today, the leading players leveraging their SOEs as soft power projection vehicles are China and Russia, each of which has overseen a concerted strategy over the past 15 years of deploying their SOEs abroad and expanding their global reach. They require considerably greater attention by national security professionals that are presently more accustomed to thinking about economic and financial issues in terms of illicit activity, money laundering and official sanctions and designations than they are seemingly legitimate commercial engagements.

We should care, however, about a $20 billion loan by Bank of China to a cash-strapped Venezuela as advance payment for future oil deliveries. We should care about a "no bid" $14 billion contract won by Russia's state-owned nuclear company, Rosatom, to develop the Paks nuclear power plants of Hungary, a NATO and EU member state. We should care about an

attempt by Rosatom to acquire the leading power producer of Slovakia, another NATO member state, and efforts by a Russian SOE to acquire 49% of Croatia's biggest energy company, INA.

If the traditional limitations of what it means to "follow the money" persist within our foreign policy and national security establishments, we will be chasing suitcases of cash and freezing isolated bank accounts for years to come while these more strategic levels of economic and financial statecraft and threat finance continue unmonitored, un-responded to and unmolested.

THE LESSONS OF "PIPELINE POLITICS"

A community of voices has existed for years that challenge the notion that the operations and business decisions of state-owned or state-controlled enterprises should be met with this level of skepticism and, they might say, cynicism. It is argued that such companies bring needed – and welcome – foreign capital and have global track records of conducting prudent, commercially-minded business transactions. These are not new perspectives and they are raised each time the investments of SOEs are called into question or subject to special review.

In the early 1980s, this debate was a fundamental part of one of the most heated transatlantic disputes in the history of the alliance, which erupted over export controls imposed by the Reagan Administration on U.S.-sourced equipment and technology that was destined, directly or via Western European engineering firms, for the development of the Soviet Union's mammoth two-strand, trans-Siberian gas pipeline project. Had that pipeline been completed along its original timeline and scale, it would have nearly doubled Soviet annual hard currency earnings during a period where cash flow was critical to the sustainability of the empire. It would also have created a 70-plus percent dependency among our Western European allies on Soviet-supplied natural gas (rather than 30-35 percent today). The lead Soviet actor on this project was Gazprom, then – and still today – one of Russia's most important and strategic state-owned enterprises.

One of the principal arguments in the acrimonious debate that ensued was that these export controls and subsequent sanctions needlessly politicized cross-border energy projects that, it was argued, would be immune to geopolitical whims and serve as symbols of mutual cooperation and co-dependency. It was vehemently argued that pipelines never had been – and never would be – used for strategic leverage or "weaponized" by one state against another.

Today, sadly, we know better. The term "pipeline diplomacy" is an established part of the foreign policy lexicon thanks to numerous examples of Moscow turning off the flow of gas to neighbouring states over pricing and diplomatic disputes, causing energy supply disruptions that have periodically reached Western Europe. It is not just Moscow that is guilty of such acts. Sudan has repeatedly disrupted the flow of oil from a shared pipeline with South Sudan that takes that oil to Bashayer Port on the Red Sea for export.

Ukraine's dependency on Russian gas played prominently in the drama that led to the annexation of Crimea and the ongoing conflict in Donetsk and Luhansk. Europe's dependency on Russian gas likewise played prominently in the degree of flexibility and political will it has been able to muster to combat Russian provocations. In the recent South Stream pipeline debate, it was the Europeans that rejected the project due to the very concerns that were so vehemently dismissed some 30+ years ago. Supply disruptions and Moscow's use of "pipeline diplomacy" was the primary impetus behind the European Commission's adoption of the so-

called Third Energy Package in November 2007, which laid the groundwork for the successful resistance displayed by the Europeans against South Stream, even in the face of pro-Russian governments within its own membership that pushed hard for the deal to be approved.

The reality, then and now, is that leveraging SOEs to serve strategic functions is a natural outcome of countries with global foreign policy agendas also having control of their largest and most international business entities. In fact, it would be odd if the two were not mutually reinforcing.

THE CASE OF CNOOC AND OFFSHORE DRILLING

Throughout the debate in Canada over whether CNOOC should be permitted to acquire Nexen and what the various policy considerations ought to be going forward, discussion of the threat represented by CNOOC to Canadian interests was made out by skeptics to be hypothetical. They worried about deterring needed foreign capital and believed that the perceived risks put forward by the security community were inflated and driven by an irrational fear of what might happen, rather than what was to be reasonably expected. What was to be expected, they argued, was for CNOOC to behave as any other multinational company would, despite embarrassing comments attributed to the company's CEO at a closed company meeting that he viewed CNOOC's offshore drilling rigs to be mobile national territory and strategic weapons of the state. These comments were brushed aside as rhetoric and not consistent with the purely benign, commercial track record of the company.

In May 2014, however, a CNOOC operated drilling rig, accompanied by a flotilla of Chinese PLA naval and other vessels, served as a central pawn in a near-military conflict between China and Vietnam that erupted, predictably, when the giant deep-water rig was provocatively deployed near the contested Paracel Islands offshore Vietnam. The oilrig was called the Haiyang Shiyou 981 and was the country's first deep-water rig, a 138-meter high platform capable of operating in 3,000 meters of water. The Vietnamese Coast Guard sought to obstruct the maneuvering of the rig. There were numerous physical clashes between boats and even violence onshore between Vietnamese and Chinese citizens. Some Chinese were even evacuated from Vietnam and China announced – in another telling maneuver – that, on June 8, it had instructed its SOEs to cease business with Vietnam as a punitive measure.

At sea, one report documented an estimated 115 Chinese ships, including 40 Coast Guard boats, 30 cargo vessels and tugboats, 45 fishing vessels and six war ships and reconnaissance aircraft accompanying the drill rig. China had initially insisted that the rig would stay at its location until early August, but, after several maneuvers, it left the area in mid-July. China later announced that it intended to move additional rigs into the disputed area in the future. No doubt, most will be owned and operated by CNOOC.

Equally tense is the dispute between China and Japan over the Senkaku Islands in the East China Sea, which is likewise complicated by undersea gas fields that lie on either side of a disputed median line that demarcates the exclusive economic zones of each country. CNOOC is already active in the prospecting of these areas and, in September 2014, it was reported that the country's second deep water drilling rig, called the Kaixuan-1, was on its way (operated by CNOOC) to an undisclosed location in the East China Sea. Given these circumstances, it is not difficult to understand why the Vietnamese and Japanese governments might regard CNOOC as less than a benign, purely commercial actor in these dangerous episodes. One would doubt that

they – or any other Chinese SOE – would be invited anytime soon to explore for oil and gas in the respective waters of these two countries.

Accordingly, Canada now faces the reality that CNOOC is, indeed, at least in its simmering conflicts with neighbouring states, being used as its CEO suggested, as a strategic weapon of the state. These examples help make two useful points: 1) permitting important national assets, such as the fields formerly operated by Nexen, to be owned and administered by entities being leveraged in this manner does not seem to be a desired outcome from an overall security perspective; and 2) more broadly, the business activities of SOEs are subject to the strategic objectives of the state and, therefore, they ought to be monitored and understood by security professionals as extensions of their countries' governments.

SOE ACTIVITY AND HYBRID WARFARE

These are not isolated incidents. Russia makes significant use of its SOEs for strategic purposes, pursuing key roles in the energy sectors and power production industries of target countries, particularly its neighbours. These efforts have come in the form of attempts to purchase the gas pipeline infrastructure of neighbouring states, efforts to acquire the power production companies and assets of target countries and a concerted effort in the nuclear industry, via state-owned Rosatom, to secure contracts for nuclear power production plants at terms and conditions with which few legitimately commercial enterprises are able or willing to compete. The reason, of course, is that the terms and conditions offered make little commercial sense. They are on offer due to the perceived strategic and geopolitical benefits, which legitimate market players do not covet or pursue.

The term "hybrid warfare" has been coined to describe the way in which Russia seemingly annexed Crimea without crossing any of the conventional methods of determining whether an armed conflict or invasion was underway. Russia tried to preserve some deniability when it came to whether or not it was responsible for the rebellion of Crimean authorities against the new government in Ukraine and for the separatist movements in the Donetsk and Luhansk regions. They have done so by having their troops wear nondescript green uniforms to fight alongside alleged rebels and vehemently denying the obvious reality that cross-border incursions were being made in support of the separatist movement. They have also done so, however, through the use of economic and financial strategies to prepare the environment for what has unfolded over the past 12 months.

In the four years leading up to the annexation of Crimea, there was a barrage of proposals and offers targeting Ukraine's critical infrastructure, defence industrial complex and most importantly industries from a revenue and employment perspective. The metallurgy industry was targeted by a string of merger and acquisition attempts, the country's pipeline infrastructure was demanded in exchange for favourable pricing terms on gas purchases and its banks were deployed to increase their exposure to Ukraine at a time, post-financial crisis, when other banks were leaving. Indeed, the era of former Ukrainian President Viktor Yanukovych was marked by more than just corruption and incompetence, but also by a concerted effort by Moscow to acquire as much of the country's strategic industrial assets as possible, an effort that even Yanukovych blanched at when the sheer scope of their demands made them politically untenable – even for him.

The strategic posturing of SOEs has occurred elsewhere as well. We have seen:

- the acquisition of Germany's fiber-optic backbone by a Gazprom subsidiary;
- the alleged use of Bank of Kunlun (a subsidiary of China National Petroleum Corporation) used by Iran's Quds force to process large-scale financial transactions;
- Rosatom signing a contract to expand Iran's Bushehr nuclear power plant complex in the final days leading up the November 24 deadline in the negotiations between Iran and the P5+1;
- the pursuit of a project by China's HKND to develop a trans-oceanic canal across Nicaragua that would compete with the Panama Canal;
- Russian oil majors signing an MOU for exploration and development in Cuba's offshore waters (in the same window as Moscow forgiving $32 billion of Cuban debt);
- the sweetening of competitive bids by SOEs with defence items, such as the case when Rosatom's winning bid to construct Vietnam's nuclear power plants occurred in the same window as the sale of submarines and military aircraft;
- a pattern of investment in the transportation infrastructure of resource-rich and strategically-located countries, including a flurry of port and railroad construction contracts in Africa and elsewhere; and
- the rapid proliferation of telecommunications networking infrastructure projects (mostly won and administered by China's Huawei, an ostensibly private company suspected of being under the influence of the Chinese military).

MARKET REACTION

There is clearly a predisposition in the markets to treating SOEs as normal market actors that are motivated basically by the same factors as the partners and customers with which they interact. There are seldom any special, self-imposed SOE-related terms and conditions in competitive bidding situations or other private sector transactions. In general, market participants want as many options as possible to deliver the best return on investment, the most value for shareholders or, in bidding situations, work done at the most competitive price and on the most favourable terms. Depending on the situation, winners and losers are determined based on pricing, financing and expectations of quality and overall competence.

This ignores a number of fundamental issues that have national and international security implications as well as, perhaps, nearer term business risks that may be unexpected on account of a lack of understanding of who these entities are and the rationale behind their negotiating positions. In general, market players feel little responsibility to figure out these risks on their own or to turn down favourable deals on account of issues that are outside of their area of responsibility. The business risk associated with these deals, however, can also be easily overlooked by market players that are performing less diligence than ought to be the case.

If there are national security-driven considerations to be accounted for, they would expect it to be the duty of their respective governments to intervene and, furthermore, they would expect any necessary action taken on their part to be a requirement. If the rules permit it and profit margins are good, market actors will continue to embrace these entities.

Although this is shortsighted because of the special risks that can occur due to the complicated business motivations of SOEs, the onus does appear at this time to sit primarily with policy-

makers to assess the reality underlying some of these investments, including the national security agendas of their home governments.

THE NEW INTERSECTION OF ECONOMIC AND FINANCIAL STATECRAFT AND RISK MANAGEMENT

The international security community, and countries individually, have made significant progress since September 11, 2001 coordinating sanctions policies that target individuals, organizations and companies that have been officially identified, designated or sanctioned as bad actors. Entities are targeted for a variety of reasons, including for funding terrorism, money laundering, drug trafficking, smuggling, violating existing national and multilateral sanctions policies (such as those targeting Iran) and for engaging in criminal acts, such as human rights violations, corruption, hacking and even enabling genocide. There has been a substantial investment of time and effort in harmonizing these sanctions and enforcement policies internationally in order to minimize the damage caused by lax regulatory regimes and weak links in the international financial system.

Another major point of emphasis during this time has been ensuring that the private sector, particularly the financial industry, is adequately educated on how to comply with anti-money laundering laws, know-your-customer regulations and the specific "red lines" associated with sanctions policies. Over the past several years, the U.S. has imposed enormous fines on a number of high profile banks that has accelerated the seriousness with which the private sector takes these issues. Today's banks and other private sector players are more dedicated than ever to avoiding transactions that have been "red flagged" by the security community.

It is even true that, to a degree, the private sector has started to appreciate that the issue of sanctions policy and the overall intersection of their business interests with international security concerns is about more than just compliance. It is a category of risk management, where even entities and transactions that have not been officially targeted can still be the source of significant uncertainty and risk. In the case of recent sanctions targeting Russian banks, this new market sensitivity has, in certain cases, led to increased scrutiny and risk assigned to SOEs – even those that are not sanctioned. This has not been a consistent phenomenon, however, and is more true of the financial sector than others, for example, energy, telecommunications, transportation, metals and mining, etc.

Most security professionals involved in the area of "following the money" are accustomed to private sector companies and banks asking themselves a very limited set of questions about a prospective, profitable business opportunity. "Is it legal?" "If not, how might we structure the transaction to make it legal?" The U.S. Treasury Department's Office of Terrorism and Financial Intelligence under the leadership of Undersecretary Stuart Levey worked hard during the Bush Administration to institutionalize the concept of "reputational risk," seeking to persuade the private sector that, just because something was legal did not mean that it was a good idea, or free of risk. The premise was that companies and banks exposed themselves to liability by conducting business in, or with, risky regimes on account of the many unknowns that come along with such business, the prospect of negative market reactions to such business and the possibility of such behaviour becoming illegal at some future time.

The market's recognition of "reputational risk," however, was elusive. The central point of focus was business activity with Iran, which did not materially diminish until the EU joined the fray in

July 2010, imposing its own comprehensive energy and financial sanctions on Iran and reinforcing a new, more global market perception that business with Iran was truly risky, not just a U.S. compliance issue. More recently, the string of hefty fines levied against banks found to be violating U.S. sanctions policy – punctuated by the $8.9 billion penalty issued against BNP Paribas in June 2014 – was something of a game-changer in altering the mindset of the private sector on sanctions policies and risk management.

In part, as a result, we have seen an enhanced market reaction to the recent sanctions imposed on Russian entities. The actual type and scope of activity targeted was relatively constrained – at least initially. Nevertheless, many banks chose simply to avoid doing business with these entities completely. The uncertainty and risk were simply too great.

BOTTOM LINE

The state of sanctions policy today and the sensitivity of market players to getting caught in "improper" business relationships provides a platform to build off of in terms of bringing adequate scrutiny to the global business agendas of state-owned enterprises. In general, however, there has not been a systemic sea change in how the broader pool of SOEs is perceived – by government or the markets. Targeted sanctions and designations still dominate the way in which governments think through their roles and responsibilities in the economic and financial "threat domain." And market players are primarily concerned with not getting caught in this net and are reeling, perhaps only temporarily, from a series of major fines that were relatively arbitrary in their enforcement and, the basis for which, is still not very well understood by the industry. In fact, the perceived arbitrariness of these actions has led to a lot of discontent and even official diplomatic complaints.

The crux of the matter that remains insufficiently treated by governments and market players is the issue of how to handle legal transactions that pose national security challenges. This was a difficult undertaking for Undersecretary Levey at Treasury in the case of Iran and it remains one today for those concerned with the dual-purpose agenda of many SOEs operating internationally. A good place to start would be situational awareness concerning precisely what these SOEs are doing and why. The proper questions need to be asked and false impressions need to be undone before appropriate policy responses can be put in place.

About the Author

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