Korea Institute for International Economic Policy

KIEP STAFF PAPER 17-01

Applying Competition Policy to Optimize International Trade Rules

LEE Hyo-young
Korea Institute for International Economic Policy

KIEP Korea Institute for International Economic Policy

February, 2017

Applying Competition Policy to Optimize International Trade Rules

LEE Hyo-young*
Korea Institute for International Economic Policy (KIEP)

Abstract

This paper delves into the relationship between trade and competition, which has long been a subject largely untouched since the issue had been dropped from the multilateral trade agenda in 2003. The need to incorporate elements of competition policy into international trade rules has long been discussed in the context of making the international trade regime more effective. The issue has gained more attention as state-owned enterprises (SOEs) began to emerge as new influential players in the international market, competing with private enterprises on an unequal footing. A growing number of bilateral trade agreements have included chapters on competition policy, albeit with rules that do not have sufficient binding force for disciplining the business practices of state-owned enterprises. The recently concluded Trans-Pacific Partnership (TPP), however, has introduced innovative rules for disciplining the competitive practices of SOEs by integrating the existing WTO disciplines on subsidies with competition rules. In this article, "competitive neutrality", the fundamental principle underlying the SOE disciplines, is used as a framework of analysis for understanding the new disciplines and obligations in the SOE rules. Several legal issues and challenges are identified that are relevant for applying the new rules in the real world, and implications are derived for future rule-making involving other new trade issues.

JEL Classification: K33, L32, L41

Keywords: Competition policy, State-owned enterprises, Subsidies, WTO, TPP

* Associate Research Fellow, International Trade Division, Korea Institute for International Economic Policy (KIEP). Views expressed in this paper are those of the author and do not necessarily reflect those of KIEP.

Contents

1. Introduction

International trade agreements have long sought to incorporate rules on competition policy as part of efforts to further lower barriers to trade and investment. Antitrust activities and collusive relationships between businesses and governments have served as another form of non-tariff barrier that effectively hamper access to markets by foreign competitors. Despite the years of efforts in liberalizing trade through multilateral and bilateral trade agreements, anti-competitive practices can undermine the gains from trade in various ways.

Competition policy is a central element of "inclusive" growth and liberalization. Enforcing competition rules can effectively operate to counter cartels or abuse of dominant positions, and other anti-competitive practices that undermine competitive opportunities and development. If competition rules and policy are effectively implemented, it can ensure that trade and investment are open and inclusive to participation by all competitive suppliers.

The issue has gained more attention since SOEs have emerged as a new influential player in today's international trade and investment, as they have grown beyond national borders and expanded their activities globally. According to OECD (2013), of the world's largest 2000 companies (listed by *Forbes Global 2000*), 204 have been identified as SOEs in the business year 2010-2011, and the combined sales of the 204 SOEs represent more than 10% of the aggregate sales of the 2000 largest companies, while the value of sales of these SOEs amounts to almost 6% of world GDP.[1] Therefore, disciplining the business practices of SOEs where they compete with private competitors is an imperative task for growth of the global economy in terms of enhanced economic efficiency and welfare.

A growing number of bilateral trade agreements have included chapters on competition policy, albeit most with rules that do not have sufficient binding 'teeth' for disciplining the business practices of state enterprises. However, more recently, new rules for disciplining competitive practices of state-owned enterprises (SOEs) have been introduced as part of the Trans-Pacific Partnership (TPP) with membership representing more than 40% of the world GDP. The concept of "competitive neutrality" underlies these disciplines, which is about creating a "level playing field" in markets where SOEs compete with private firms so that SOEs do not enjoy advantages over their private competitors by virtue of government ownership.

This paper examines the new disciplines on SOEs in the TPP with particular focus on how the application of competition rules in trade agreements have contributed to providing better disciplines with the intended effects. There may still be lack of clarity on how the new rules would be applied in the real world, but derivations can be made from the existing provisions in GATT/WTO agreements. Furthermore, in assessing the significance and impact of the TPP SOE chapter, there need be consideration of not only the various exception clauses within the SOE chapter, but also lists of non-conforming measures that the members submitted for exemption

[1] Kowalski, P. et al. 2013. "State-Owned Enterprises: Trade Effects and Policy Implications", OECD Trade Policy Papers No. 147, OECD Publishing, at 6.

from the SOE commitments. The inclusion of such exceptions appears to be an inevitable outcome of multilateral trade negotiations where flexibilities are needed to conclude negotiable deals, but with results that that can potentially undermine the effectiveness of the SOE rules.

To this end, Part II first reviews the historical context for competition policy in trade agreements, and examines the existing provisions on competition matters in GATT/WTO agreements and several recent WTO disputes that inadequately address SOEs which led to the birth of the SOE disciplines. Part III examines the principle of "competitive neutrality" and the required elements in rule-making to realize competitive neutrality, to provide a framework for analysis of the SOE rules. Part IV analyzes the new disciplines and obligations incorporated in the SOE chapter, and identifies important legal issues that need further clarification to apply the new SOE rules in the real world. Lastly, Part V concludes by summarizing the significance of the TPP SOE rules from the competition policy perspective, and draws implications for future rule-making for other new trade issues.

2. Historical Context for Competition Policy in Trade Agreements

2.1. Interface between Competition and International Trade

Competition policy is traditionally a domestic economic policy that aims to enhance economic efficiency and consumer welfare by restraining anti-competitive practices in the domestic market. However, in today's globalized world of trade and investment, the scope of application has grown to become more international, as companies have become more global and their business activities take place across borders.

In an ideal world where there are no impediments to trade and investment, where inputs for production of goods and services are fully mobilized, international trade would be the main source of market competition and efficiency. However, in the real world where there is less than full mobility of inputs and products, market imperfections, and regulatory distortions, international trade cannot work effectively. Competition policy and enforcement, which concentrate on the elimination of private incentives to restrain competition, can complement international trade.[2]

Competition policy and international trade share the same objective of enhancing economic efficiency and consumer welfare based on trade liberalization and open markets.[3] While they share the same goal, they have different means of achieving it. While competition policy and law enforcement focus on the elimination of private incentives to restrain competition such as

[2] Perez Motta, Eduardo. 2016. "Competition Policy and the Trade System: Challenges and Opportunities", E15 Expert Group on Competition Policy and the Trade System – Overview Paper, International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum, at 1.

[3] Matsushita, Mitsuo, Thomas J. Schoenbaum, Petros C. Mavroidis. 2006. The World Trade Organization: Law, Practice and Policy (second edition), Oxford University Press, at 852-853; WTO, Report (1998) of the Working Group on the Interaction between Trade and Competition Policy to the General Council, WT/WGTCP/2 (8 December 1998), paras. 22-23.

unilateral conduct, cartels and mergers, international trade policy concentrates mostly on the elimination of regulatory barriers to international trade flows.[4]

Restraining private incentives that distort competition is particularly important in the services sector due to its unique characteristics. This is because services are normally non-tradable, mainly due to high transportation costs or the existence of regulatory barriers. Services, especially in the telecommunications and transport, financial services, and energy sectors, have highly concentrated market structures due to economies of scale and economies of networks.[5] Consequently, the services sector requires a regulatory framework for maintaining competition principles and effective competition law enforcement. This line of reasoning also provides explanation for the broadened scope of application of the disciplines in the TPP SOE chapter that covers not only trade and investment in goods, but also services, especially in the financial services, energy and SOC sectors.

2.2. Unsuccessful Attempts to Bring Competition Policy into the WTO Trade Agenda

There have been attempts to bring competition matters into the WTO multilateral trading system mainly due to this interface between competition policy and trade, which can work complementarily to provide a synergy effect in achieving economic efficiency and enhanced welfare. Efforts have been made, first in the form of a number of provisions incorporated in the Havana Charter for an International Trade Organization (ITO), the precursor to the WTO we now see today. Chapter V in the Havana Charter provides disciplines on a range of restrictive business practices, including provisions for dispute settlement.[6] The scope of coverage is evaluated as being broader than the current WTO rules on competition matters, which are scattered among various WTO agreements. Under this Chapter, the general policy is to mandate all members to take appropriate measures to prevent business practices affecting international trade which restrain competition, limit market access or foster monopolistic control. The relevant provision also lists various types of business practices that restrain competition.[7] The Charter has provisions on dispute settlement, including procedures for consultation among members with the aim to reach mutually satisfactory conclusions, and for investigation on whether a complaint can be justified as regards the existence of practices with harmful effects. In case of a positive determination on the existence of harmful effects, the ITO may recommend remedial action on the part of the inflicting member.[8] Chapter V also included special procedures to deal with restrictive business practices in services, such as transportation, telecommunications, insurance and commercial bank services.[9]

---

[4] Perez Motta (2016), See above n 2, at 1.
[5] *Ibid*.
[6] Havana Charter for an International Trade Organization, April 1948, United Nations Document E/Conf. 2/78, available at http://www.wto.org/english/docs_e/legal_e/havana_e.pdf.
[7] *Ibid*., Article 46. The practices include: price-fixing and fixing terms or conditions of purchase, sale or lease of product; excluding, allocating, or dividing enterprises from market or business activity; discrimination against particular enterprises; limiting production or fixing production quotas; preventing development or application of technology or invention; extending the use of intellectual property rights. Such coverage of business practices is the basis of argument for the broader scope of application of the Havana Charter.
[8] *Ibid*., Articles 47-48.
[9] *Ibid*., Article 53.

However, as the ITO and the proposed disciplines in the Havana Charter never came into existence, efforts to incorporate competition policy and enforcement into a multilateral legal framework failed to make further progress. Instead, discussions on competition matters proceeded under the GATT system, mainly around trade remedy measures. Based on the recognition that the practices of multinational enterprises are causing harmful effects on competition in global markets, and accordingly, the need for complementing trade rules with competition policy, revisions were made to the Agreements on Anti-dumping, Safeguards, and Subsidies and Countervailing Measures. Provisions on competition matters were included in the GATS (General Agreement on Trade in Services), TRIPs (Trade-Related Aspects on Intellectual Property Rights), and TRIMs (Trade-Related Investment Measures).

In 1996, WTO members established a Working Group on the Interaction between Trade and Competition Policy (WGTCP) to study issues on the interaction between trade and competition policy, including anti-competitive practices, in order to identify areas that require further consideration in the WTO framework.[10] Special focus was placed on the impact of state monopolies, exclusive rights and regulatory policies on competition and international trade, the relationship between competition policy and trade-related aspects of intellectual property rights, and between competition policy and investment policy.[11]

In the subsequent period of 1999-2001, the Working Group pursued a refocused mandate on three additional topics: (i) the relevance of the fundamental WTO principles of national treatment, transparency and most-favored nation treatment to competition policy and vice versa; (ii) approaches to promoting cooperation and communication among Members, including technical cooperation; and (iii) contribution of competition policy to achieving the objectives of the WTO, including protection of international trade. In the discussions, a consensus was forming that WTO principles and competition policy were closely related and complementary, and there was a general agreement that cooperation among Members to address anti-competitive practices needed to be enhanced. However, there was a difference in views over the need for action at the multilateral level, and some instead favored bilateral or regional approaches for cooperation in this field.[12]

Pursuant to the Doha Ministerial Declaration in 2001, the work of the Working Group was refocused to emphasize specific elements of a possible "multilateral framework" on competition policy. In line with the decision, negotiations were to take place after the next session of the Ministerial Conference on the basis of a decision on the modalities of negotiations that would be reached by consensus. However, at the fifth WTO Ministerial Conference in Cancun, Mexico, in September 2003, the majority of WTO Members rejected launching negotiations on a multilateral framework on competition policy. The lack of agreement on the multilateral initiative can be

[10] Matsushita *et al*.(2006), See above n 3, at 894.

[11] Anderson, Robert D. and Anna Carolina Muller (2015), "Competition Law/Policy and the Multilateral Trading System: A Possible Agenda for the Future," E15 Expert Group on Competition Policy and the Trade System – Think Piece, International Center for Trade and Sustainable Development and the World Economic Forum, at 3.

[12] Matsushita *et al*.(2006), See above n 3, at 895.

explained by the higher priority placed on other issues on the negotiating table, but could be more attributable to concerns by the developing country members on their potential interests being unprotected by the outright suppression of anti-competitive practices and their lack of negotiating capacity in this area.[13]

In the subsequent official meeting of the General Council, the WTO members decided that no further work would be undertaken toward negotiations on competition, as part of the so-called "July package" of 2004.[14]

2.3. Existing Provisions on Competition and SOEs in GATT/WTO Agreements

2.3.1 Provisions on Competition Matters in GATT/WTO Agreements

Competition policy may be already an integral part of the GATT/WTO, since the principles of fair competition underlie the basic foundations of the GATT/WTO trade rules. The basic obligations of most-favored nation treatment and national treatment are fundamentally rules to ensure a level playing field among all players in the market and between domestic and foreign competitors.

There are several provisions addressing competition matters in the existing WTO agreements, particularly in areas where anti-competitive practices cause more harmful effects. One of these areas is standard-setting, which has been recognized as a competition policy matter when it is performed by private entities in a discriminatory manner. This is because private entities often form trade associations that perform product tests and issue certificates for products that meet technical regulations and standards, and may discriminate against products from non-members or importers.[15] To address this problem, the TBT Agreement provides that "Members shall not take measures which have the effect of, directly or indirectly, requiring or encouraging such bodies [non-governmental bodies assessing conformity of products to technical regulations and standards] to act in a manner inconsistent with the provisions of Article 5 and 6."[16] Articles 5 and 6 of the TBT Agreement provides that, in the assessment of conformity by central government bodies, the principle of national treatment must be observed, technical regulations must not be more trade-restrictive than necessary, and mutual recognition of technical regulations must be promoted.

The GATS has several provisions addressing competition matters related to monopoly service suppliers. Article VIII:1 of the GATS provides that "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." Article II of the GATS provides for most-favored nation treatment. Therefore, a Member must ensure that a monopoly enterprise providing services in its territory accords persons from any Member country treatment no less favorable than that which it accords to persons from any other Member country. Also, Article VIII:2 of the GATS provides that "where a Member's

---

[13] Anderson and Muller (2015), See above n 11, at 4.
[14] Decision Adopted by the General Council on 1 August 2004 ("July package"), WT/L/579 (2 August 2004), available at: http://www.wto.org/english/tratop_e/dda_e/dda_package_july04_e.htm.
[15] Matsushita *et al*. (2006), See above n 3, at 859.
[16] WTO, Agreement on Technical Barriers to Trade (TBT Agreement), Article 8.1.

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." Therefore, if a Member grants monopoly to one enterprise in the area of railway transportation and has made a commitment in the area of trucking that it would accord the national treatment to enterprises of any other Member, it must ensure that the monopoly enterprise does not abuse its monopoly power by engaging in predatory pricing or any anti-competitive practice in this area.[17]

The Safeguards Agreement also prohibits voluntary restraints of trade and orderly marketing agreements, and forbids Members to "encourage or support the adoption or maintenance by public and private enterprises of non-governmental measures equivalent to those referred to in paragraph 1," referring to any cartels entered into among enterprises.[18]

In TRIPs, Article 40 provides rules on the control of anti-competitive practices in contractual licenses, based on the recognition that licensing practices or conditions related to intellectual property rights not only impede the transfer and dissemination of technology, but can restrain competition and cause adverse effects on trade.

2.3.2 Provisions on Competition involving SOEs in GATT/WTO Agreements

The GATT provides rules to discipline 'state-trading enterprises' based on the recognition that state-trading enterprises can easily disrupt or take advantage of the principles of free trade by certain discriminatory or anti-competitive practices that result in tilted trade flows.[19] Rules for addressing state-trading enterprises are principally incorporated in Article XVII of GATT, which mainly provides for a general definition of state-trading enterprises, transparency (notification) rules, and major substantive obligations.

Article XVII:1(a) provides a rather broad definition of state-trading enterprises, as an enterprise that benefits from "exclusive or special privileges." The Illustrative List of Relationships between Governments and State Trading Enterprises, which was adopted by the WTO Goods Council in October 1999, provides that such enterprises may be governmental or non-governmental entities that are granted exclusive or special rights or privileges, and which influence through purchases or sales the level of direction of exports and imports.[20]

Under Article XVII, state-trading enterprises are subject to three major obligations: (i) in its purchases or sales involving exports or imports, they must act in a manner consistent with the principles of non-discriminatory treatment for governmental measures affecting imports or exports

[17] Matsushita *et al*. (2006), See above n 3, at 860-861.
[18] WTO, Agreement on Safeguards, Articles 11.1 and 11.3.
[19] Such recognition is expressed in GATT Article XVII:3, which states: "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."
[20] Matsushita *et al*. (2006), See above n 3, at 275-276.

by private traders;[21] (ii) make any purchases or sales solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale;[22] and (iii) afford the enterprises of other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales.[23] In more general terms, state-trading enterprise are held liable for the national treatment obligation when engaging in commercial activities of purchasing or selling goods that are exported or imported, and to adhere strictly to "commercial considerations" when making such purchases or sales. Furthermore, state-trading enterprises must provide open competition for all domestic and foreign applicants in purchase or sales contracts.

2.3.3 Limitations of the Existing Rules in GATT/WTO regarding Anti-Competitive Practices of SOEs

One of the limitations of the provisions on state-trading enterprises in Article XVII of GATT 1947 is that the disciplines apply only to state enterprises that are involved in international trade. This is based on the recognition that state-trading enterprises can cause serious obstacles to trade, and thus the provisions mandate the adherence to non-discrimination obligations and commercial considerations in the purchase or sales of traded products. As a result, state enterprises that are suppliers of products or services mainly in the domestic market are not subject to the disciplines, even if their business practices have impact on foreign suppliers or participants in the relevant market.

The general definition of state-trading enterprises provided in Article XVII:1(a) and the Illustrative List does not provide clear guidance on what criteria to apply for distinguishing state-owned enterprises. Furthermore, the entities that are granted "exclusive or special rights or privileges" are qualified by a linkage with trade ("which influence through purchases or sales the level of direction of exports and imports"), which again serves to narrow down the scope of application to state enterprises that engage in trade.

With regard to the "commercial considerations," there is no additional explanation of the terminology, other than the reference to conditions where "commercial considerations" are to be applied, such as "price, quality, availability, marketability, transportation, and other conditions of purchase or sale." The additional note in Ad Article XVII refers only to "tied loans" that can be taken into account as a "commercial consideration." In general, the term "commercial considerations" is taken to refer to terms and conditions on the market, such as loans with market interest rates.

However, when compared to the other provisions addressing competition matters in GATT/WTO, the provisions on state-trading enterprises can receive credit for rule-making that applies to state enterprises that engage in commercial activities with other private entities. In contrast, the competition provisions in GATT/WTO are focused on the anti-competitive activities of private

[21] GATT Article XVII:1(a).
[22] GATT Article XVII:1(b).
[23] *Ibid.*

actors, such as those engaged in standard-setting, supply of services, or export arrangements. In fact, in previous dispute cases under the GATT and WTO, addressing the issue of whether private actors are subject to the GATT/WTO obligations regarding competition policy matters, the Panels provided rulings that led to the conclusion that there is no legal basis for directly disciplining the anti-competitive acts of private entities and for proving direct association of government measures in private business activities under the GATT/WTO provisions.[24]

Nevertheless, the provisions addressing anti-competitive practices of private entities and state-trading enterprises still do not cover other types of government-created advantages that provide competitive advantages to SOEs. Government support in the form of subsidies or tax credits are usually not penalized under competition laws,[25] and accordingly escapes the scope of application of the existing GATT/WTO provisions that discipline anti-competitive practices.

More recently, a few number of disputes were brought to the WTO Dispute Settlement Body (DSB) regarding the application of the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement) on SOEs. In *U.S. – Countervailing Measures*, the issue was whether certain SOEs in China were "public bodies" within the meaning of Article 1.1(a)(1) of the SCM Agreement, which was the basis for the USDOC (U.S. Department of Commerce) countervailing duty investigations on products from China. In initiating the investigations, the USDOC had applied an "ownership-based control" test in determining whether Chinese SOEs were public bodies, by assuming that the relevant input suppliers were public bodies on the ground that these suppliers were majority-owned or otherwise controlled by the government.[26] In identifying the appropriate legal criteria for the "public body" determination, the Panel confirmed the prior interpretative analysis by the Appellate Body in *U.S. – Anti-Dumping and Countervailing Duties* which found that the critical consideration in identifying a public body is the question of "authority to perform governmental functions," rather than mere evidence of majority government ownership.[27] Based on the reasoning that the USDOC found that SOEs were public bodies based solely on the grounds that these enterprises were majority owned, or otherwise controlled, by the

[24] Refer to GATT Panel Report, *Japan – Trade in Semi-Conductors*, BISD 35S/116 (adopted on 4 May, 1988); WTO Panel Report, *Japan – Measures Affecting Consumer Photographic Film and Paper*, WT/DS44/R (adopted 31 March 1998). Kwon, Hyunho (2003), "Study on the Applicability of Competition Law in International Trade," *국제경제법연구*, 12(2), at 18, 25-26 (*in Korean*).

[25] Kowalski *et al*. (2013). See above n 1, at 38.

[26] WTO Panel Report, *United States – Countervailing Duty Measures on Certain Products from China*, WT/DS437/R, adopted 16 January, 2015, at para. 7.63.

[27] The Appellate Body in *U.S. –Anti-Dumping and Countervailing Duties* conducted a lengthy analysis of the interpretation of "public body" in Article 1.1(a)(1) of the SCM Agreement. It reversed the Panel's interpretation that the term "public body" meant "any entity controlled by a government" and reversed the Panel's ruling which basically accepted USDOC's determination that was based on a "rule of majority ownership" as the legal criteria for determining whether it is a "public body." The Appellate Body concluded that "the existence of mere formal links between an entity and government in the narrow sense is unlikely to suffice to establish the necessary possession of governmental authority" (para. 3.18), and that "evidence of government ownership, in itself, is not evidence of meaningful control of an entity by a government and cannot, without more, serve as a basis for establishing that the entity is vested with authority to perform a governmental function" (para. 346). WTO Appellate Body Report, *United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, WT/DS379/AB/R, adopted 25 March, 2011.

government of China, the Panel concluded that the U.S. acted inconsistently with the SCM Agreement.[28]

In a subsequent, closely related dispute case, the Appellate Body also found that the USDOC's determination that the National Mineral Development Corporation (NMDC) is a public body is inconsistent with Article 1.1(a)(1) of the SCM Agreement. In reaching this finding, the Appellate Body followed the interpretation of the Appellate Body in *U.S. – Anti-Dumping and Countervailing Duties*, and noted that a public body must be "an entity that possess, exercises or is vested with governmental authority," and "mere ownership or control over an entity by a government, without more, is not sufficient to establish that the entity is a public body."[29] Furthermore, the Appellate Body confirmed that in order to conduct a "public body" determination, the Panel would need to properly consider the extent to which the government in fact 'exercised' meaningful control over the SOE as an entity and over its conduct," rather than relying on evidence of mere "formal indicia of control," such as "the Government of India (GOI)'s ownership interest in the NMDC, the GOI's power to appoint and nominate directors, and the reference on the NMDC's website indicating that the NMDC is under 'administrative control' of the GOI."[30]

As can be seen from the above WTO DSB rulings involving SOEs, the current WTO rules fall short of providing sufficient discipline on SOEs. The outcome of the recent WTO disputes between the U.S. and China regarding Chinese SOEs seems to have strongly influenced the inclusion of a separate, stand-alone SOE chapter in the TPP, with clear criteria for identifying SOEs within the meaning of the TPP SOE chapter. Before analyzing the new disciplines on competition and SOEs in the TPP provisions, we first examine the principle of "competitive neutrality," which underlies the major obligations in the TPP SOE provisions.

3. Competitive Neutrality and Guidelines for Governance of SOEs

3.1. The Principle of "Competitive Neutrality"

Although the TPP SOE chapter does not explicitly use the term "competitive neutrality" in any part of its text, it is generally understood, based on the discussions on competition matters relating to the practices of government businesses in global markets, that this principle lays the 'theoretical' framework for the TPP SOE rules. Based on this understanding, it would be essential to review what 'competitive neutrality' is and what elements it is comprised of.

The concept of competitive neutrality has its origins in the Hilmer Review,[31] a report published by an independent committee which set out principles for competition policy reforms for the

[28] WTO Panel Report, *U.S. – Countervailing Measures (China)*, above n 26, para. 7.75.
[29] WTO Appellate Body Report, *United States – Countervailing Measures on Certain Hot-Rolled Carbon Steel Flat Products from India*, WT/DS436/AB/R (adopted 19 December, 2014), paras. 4.7-10.
[30] *Ibid.*, paras. 4.43-46.
[31] Hilmer, F. G., M. Rayner, G. Taperell (1993), *National Competition Policy*, Report by the Independent Committee of Inquiry, 25 August 1993.

Australian government.[32] One of the six elements of competition policy identified by the Hilmer Review was "competitive neutrality," so that government businesses do not enjoy unfair advantages when competing with private businesses. The remaining five priority areas for which restriction or reform was proposed were: (i) anti-competitive conduct of firms; (ii) regulatory restrictions on competition; (iii) structure of public monopolies which restrict competition; (iv) restriction on access to facilities essential to competition; and (v) monopoly pricing.[33] A strong theme throughout the Hilmer Review was that market-based mechanisms should be implemented to address the priority policy recommendations, rather than using regulatory solutions. This was recognized to mean that certain changes to legislation would need to be implemented, particularly in the competitive neutrality area, to establish the desired outcome of a "level playing field."[34]

The concept of competitive neutrality relates to a drive to ensure that, in situations where public enterprise and private enterprise compete, or could potentially compete, in the provision of goods and services in a market, both the public entities and the private entities are essentially subject to the same external environment. Although there are inherent differences between public and private entities, government ownership of SOEs has resulted in SOEs being systematically subject to different external conditions (i.e. regulatory, financial, reporting) than those applied to private entities. This has resulted in distortions where these entities could compete with one another within that market. Generally, the SOEs were seen as having a variety of competitive advantages over private enterprises, which were generally viewed as inequitable by the private sector.[35]

The Hilmer Review also enunciated a set of principles[36] aimed at guiding the development of policy to achieve competitive neutrality in relevant industry sectors, but without introducing unnecessary impediments to the operation of enterprises within these sectors. These principles are:

- Government businesses 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 neutralize any net competitive advantage flowing from their ownership.

- Government businesses should not compete against other businesses outside their traditional markets without being subject to measures that effectively neutralize any net competitive advantage flowing from their ownership.

---

[32] Yun, Mikyung (2016), "An analysis of the New Trade Regime for State-Owned Enterprises under the Trans-Pacific Partnership Agreement", *Journal of East Asian Economic Integration* 20(1), at 23.

[33] Hilmer, Frederick G. (1995), "Competition Policy: Underlying Ideas and Issues", University of Western Australia, Discussion Paper 95.18, at 3.

[34] Rennie, M. and F. 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, at 7.

[35] *Ibid*., at 11.

[36] Hilmer Review, n 31, pp 305-307.

Ultimately, the objective of competitive neutrality policy is "the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities. Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to non-business, non-profit activities of these entities."[37]

It is important to note that the competitive neutrality reforms were intended to specifically address those distortions arising purely as a result of government ownership. Competitive neutrality reforms were not intended to put all businesses (including both public and private) on a completely 'equal footing', since various businesses have various inherent size, expertise, efficiency, managerial competence, or other advantages, nor require the sales of assets and privatization of all SOEs and consequently reduce the size of the public sector. Neither were they intended to require governments to open the in-house provision of goods and services to competition and contract out the delivery of goods and services, nor imply that SOEs cannot be successful when operating in competitive markets by relying on their own merits.[38]

3.2. OECD Guidelines on Competitive Neutrality and Governance of SOEs

The OECD first developed the OECD Guidelines on Corporate Governance of SOEs in 2005 after having studied competition matters related to government businesses from a variety of perspectives for more than a decade. The Guidelines were updated in 2015 to reflect a decade of experience with implementation and to address new issues concerning SOEs. Due to the extensive work on competition and competitive neutrality issues involving SOEs conducted by the OECD, understanding the OECD studies on competitive neutrality provides a framework for analysis of the TPP SOE rules. In particular, the guidelines for good corporate governance of SOEs proposed by the OECD offer important insight on how governments that are, or could be potentially affected by the new rules may respond in terms of institutional or legal reforms regarding the governance of SOEs.

According to the OECD explanation of competitive neutrality, it can be understood as a "legal and regulatory environment in which all enterprises, public or private, face the same set of rules, and government ownership or involvement does not confer unjustified advantages on any entity."[39] In other words, the application of competitive neutrality principles would ensure that all economic entities in the relevant market would compete on a level playing field. There are both economic and political rationales for pursuing competitive neutrality. Despite the awareness of the economic benefits of competitive neutrality, governments tend to make deliberate decisions that pursue non-neutral practices in the interest of public policy or other reasons. Under these circumstances, the economic rationale for pursuing competitive neutrality is to enhance efficient allocation of resources throughout the economy, and, from a more political perspective, strengthen the

[37] Competition Principles Agreement, clause 3(1).
[38] Rennie, M. and F. Lindsay (2011), See above n 34, at 14.
[39] OECD (2009), "State Owned Enterprises and the Principle of Competitive Neutrality," OECD Competition Committee, DAF/COMP(2009)37, at 11.

government's regulatory role in ensuring that economic actors are playing by the rules and that public service obligations are being met.[40]

There are eight priority areas that need to be addressed by national authorities for applying the principle of competitive neutrality between public and private providers of goods and services.[41] First, governments need to streamline the operating structure of government businesses (SOEs) so that the role of SOEs in providing public policy functions may be clarified by separating the competition and non-competition functions. Second, high standards of transparency should be introduced by disclosing the cost structures of SOEs to ensure that remuneration of public service obligations are calculated based on clear targets and objectives. This would also prevent the cross-subsidization of commercial activities by compensation provided by the public service obligations. Third, SOEs that operate commercial activities should earn rates of return that are comparable to private entities, and not allow for "reasonable profits" which enable cross-subsidization from profit-making activities to loss-making ones. Fourth, where SOEs are required to perform public policy functions, adequate compensation should be made in a transparent manner. The modes of compensation can take several forms, such as compensation by "thresholds" to compensate losses incurred by SOEs, by "reasonable profits" which allow for cross-subsidization from profit to loss-making activities, or by "direct payment" provided from public sector budgets. Calculation should be based on transparent and neutral methods, accounting for cost structures of the entity and ensuring that compensation does not amount to undue subsidies. Fifth, equal tax treatment of both government and private businesses is important for competitive neutrality. OECD emphasizes that careful consideration should be made in order to ensure that government is not provided any incentives to avoid paying taxes, such as government purchase of goods and services from itself to avoid taxation. Sixth, SOEs should be subject to the same, or at least similar, regulatory treatment as private businesses. Should there be any regulatory exemptions as compensation for public service obligations, they would be transparent and narrowly established. Seventh, debt neutrality is important for establishing a level playing field between government and private businesses. SOEs should be subject to financial market disciplines and not provided concessionary financing. In other words, financing for SOEs should be provided on commercial terms and based on market benchmarks. Lastly, procurement policies and procedures should be competitive, non-discriminatory, with high standards of transparency. In particular, in-house bids should be treated the same as outside bids, and neutrality should be ensured between private and public suppliers.

Based on this understanding, the OECD recommends several guidelines for achieving good corporate governance of SOEs.[42] The aim is to provide governments with recommendations on how to ensure that SOEs operate efficiently, transparently, and in an accountable manner. They are also internationally agreed standards for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state ownership. This is based on the recognition that state-owned sectors may either promote or hamper economic and social

[40] OECD (2012b), "Competitive Neutrality: Maintain a Level Playing Field between Public and Private Businesses," at 22.
[41] OECD (2012a), "Competitive Neutrality: A Compendium of OECD Recommendations, Guidelines and Best Practices," Paris: OECD Publishing.
[42] OECD (2015), "OECD Guidelines on Corporate Governance of State-Owned Enterprises," 2015 Edition, Paris: OECD Publishing.

development depending on whether SOE sectors operate according to good corporate governance and practices. The recommendations touch upon various aspects of SOE-related activities, including the definition of SOEs, ownership and control, economic activities, public policy activities, and governing bodies of SOEs.

4. New Disciplines for Competition in the TPP SOE Chapter

4.1. TPP SOE Rules: Case of Innovative Rule-Making

4.1.1 Structure and Significance

There are two chapters in the TPP which deal with competition-related measures: Chapter 16 (Competition Policy) and Chapter 17 (State-Owned Enterprises and Designated Monopolies). These chapters address competition issues in complementary ways and with larger scope of application than in any other trade agreements established so far. However, while the TPP provisions on competition policy remain rather hortatory, and without the binding force for enforcing the provisions, the newly established competition rules on SOEs stand as a separate chapter addressing a wide range of commercial business practices involving SOEs, and with binding force attached to the major obligations of the SOE chapter.

In general, the Competition Policy chapter in TPP addresses the implementation of national competition laws by national authorities through provisions on ensuring procedural fairness in competition law enforcement, the right of private persons to seek redress for injury from violation of national competition laws, cooperation among national competition authorities for effective enforcement, consumer protection, and transparency.[43] The provisions in this chapter, however, are not subject to TPP dispute settlement procedures.[44] Some explanation may be found in the fact that international competition law is essentially achieved on the basis of regulatory cooperation, or through a more "soft-law" approach. This is mainly due to the fact that competition laws have been developed as a "jurisdiction-based" regime, with each sovereign nation developing its own set of competition laws and regulations. Against this background, competing jurisdictional regimes based on sovereignty have led to efforts to achieve regulatory convergence through cooperation and collaboration.[45]

The SOE chapter is evaluated as a more revolutionary approach to rule-making, particularly in the area of competition law, with binding provisions for enforcing the rules. The SOE rules can be considered to be rather 'hybrid' in form, as it combines competition principles/laws for disciplining anti-competitive practices of SOEs and the WTO rules on subsidies for restricting provision of government assistance for SOEs' commercial activities. Therefore, understanding the context and

[43] Trans-Pacific Partnership (TPP), 26 January 2016, available at http://www.tpp.mfat.govt.nz/text, Chapter 16. Competition Policy, Articles 16.2-16.7.
[44] *Ibid*., Article 16.9.
[45] Gadbaw, R. Michael (2016), "Chapter 7: Competition Policy" in Jeffrey J. Schott and Cathleen Cimino-Isaccs (eds), Assessing the Trans-Pacific Partnership, Volume 2: Innovations in Trading Rules, PIIE Briefing 16-4, at 84.

predicting the impact of the new SOE rules would inevitably require analysis of the new rules based on the jurisprudence on WTO subsidy rules, in addition to other relevant provisions in the GATT/WTO based on usage of common terminology or concepts.

4.1.2 Definition of SOEs

One of the main achievements of the SOE rules lies first in the more specific definition of "state-owned enterprise." Under the existing WTO subsidy rules, the lack of definition on "public body" revealed the ineffectiveness of WTO rules for application on SOE activities. In a series of related dispute cases, the WTO Appellate Body made determinations on the meaning of "public body", during the process of which evidence was required to prove that the relevant entities had the "authority to perform governmental functions" rather than mere evidence of majority government ownership. As a result of these rulings, the complaining party failed to establish its case that the SOEs of the responding party had received government support and enjoyed undue advantage in foreign markets.[46]

The SOE chapter provides a rather clear-cut definition, which requires two conditions for an enterprise to be construed as an SOE within the meaning of this chapter: an enterprise that is principally engaged in commercial activities, and an enterprise of which the government has more than 50 percent ownership and voting rights, or the power to appoint majority of the board of directors.

With regard to the first condition, SOEs that are subject to the disciplines of this chapter are those SOEs that are "principally engaged in" "commercial activity." While there is no further explanation of the term "principally engaged in" within the text, the attached Annex on threshold calculations appears to provide some guidance in this regard.[47] As a result, those SOEs that fall under the first condition would be those that are engaging in commercial activities through sales or purchase of goods or services with annual revenue of more than the threshold level of 200 million SDRs.

The second condition provides practical coverage of the vast majority of enterprises that are considered to be state-owned. Not only does it include consideration of a state's share of ownership in a SOE, it also takes into account the control of the state over the enterprise. Due to the inclusion of the third optional condition, the SOE definition provides more scope for encompassing enterprises where the government has no shares or equity voting rights, but has control over the

[46] See *U.S.–Anti-Dumping and Countervailing Duties* (WT/DS436/AB/R, 19 Dec. 2014), *U.S.–Countervailing Measures* (WT/DS437/R, 16 Jan. 2015), above n 26, n 30.

[47] TPP Agreement, Annex 17-A (Threshold Calculation), Article 1: "At the time of entry into force of this Agreement, the threshold referenced in Article 17.13(5) (Exceptions) shall be 200 million Special Drawing Rights (SDRs)."

Article 17.13(5): "Article 17.4 (Non-Discriminatory Treatment and Commercial Considerations), Article 17.6 (Non-commercial Assistance), Article 17.10 (Transparency), and Article 17.12 (Committee on State-Owned Enterprises and Designated Monopolies) shall not apply with respect to a state-owned enterprise or designated monopoly if any one of the three previous consecutive fiscal years, the annual revenue derived from the commercial activities of the enterprise was less than the threshold amount which shall be calculated in accordance with Annex 17-A."

hiring of top management.[48] As a result, SOEs where the government is not a majority shareholder but still effectively controls them would fall under the criteria. In this sense, the legal criteria for qualifying as an SOE appears to have become easier to satisfy, with evidence of mere "formal indicia of control," which was found to be an insufficient criteria in the *U.S.-Antidumping and Countervailing Duties* dispute case.

4.1.3 Scope of Application

Whereas the existing rules in GATT/WTO that could be applied to SOEs were limited to disciplining products or goods, the disciplines in the SOE chapter have been significantly broadened to include cross-border trade in services (also known as "Mode 1" in GATS parlance), and supply of services through commercial presence of invested firms in the territory of the other party (a.k.a. "Mode 3"). As a result, the provision of government assistance to SOEs which largely operate in various service sectors – energy, banking, telecommunications, aviation, etc. – all fall under the disciplines of the SOE rules. In line with this broadened scope in application to services trade and investment, the SOE disciplines are effective not only in the market of the TPP party to which the SOE belongs to, but also in the markets of other TPP parties and non-TPP parties where the commercial activities take place.

The inclusion of disciplines on service subsidies needs to be noted with importance since there has been no practically no subsidy disciplines in services trade under the current WTO regulatory framework. Although there exists a provision in the GATS disciplining the anti-competitive practices of monopoly service providers,[49] its effectiveness is questionable since there has been no dispute so far brought to the WTO challenging any non-compliant activities under this provision. However, the need for effective disciplines on subsidies provided in service sectors has gained attention for a long time, albeit with lack of progress in negotiations within the WTO. As prospects for the adoption on multilateral disciplines on services subsidies remain generally grim,[50] progress in this area in the TPP SOE rules can be evaluated as a significant step forward.

The scope of application has also expanded in terms of both the 'provider' and 'receiver' of competitive favoritism and assistance. Whereas the WTO subsidy rules provided disciplines on government-provided non-conforming subsidies to private enterprises, the SOE rules apply not only to government-provided support to SOEs, but also assistance and discriminatory treatment provided to SOEs from other SOEs. The latter case would generally pertain to government-controlled financial institutions providing concessionary financing to other SOEs that would result in distorting the competitive market where other foreign SOEs and private entities participate.

---

[48] Gadbaw (2016), See above n 45, at 93.
[49] GATS, Article VIII:1.
[50] Sauve, Pierre and Marta Soprana (2015), "Learning by Not Doing: Subsidy Disciplines in Services Trade," E15 Task Force on Rethinking International Subsidies Disciplines – Think Piece, ICTSD and World Economic Forum.

Major Obligations in TPP SOE Rules

4.2.1 Non-discriminatory Treatment and Commercial Considerations

As a core principle of competitive neutrality, the TPP SOE rules provide for the obligation for governments to ensure that their SOEs act in accordance with "commercial considerations." The term "commercial considerations" is not new, but has been seen in the GATT provisions disciplining state-trading enterprises,[51] and in a number of FTAs established by the U.S.[52] However, there had not been any meaningful explanation of the term, other than mere additional examples of commercial consideration such as "price, quality, availability, marketability, transportation and other conditions of purchase or sale." The meaning of "commercial considerations" was actually determined by the WTO Appellate Body in *Canada-Wheat* as implying "to purchase or sell on terms which are economically advantageous for themselves and/or their owners, members, beneficiaries."[53] Against this background, the TPP SOE provisions provide a more refined definition compared to previous trade agreements. It provides further explanation that "commercial considerations" may be "factors that would normally be taken into account in the commercial decisions of a privately owned enterprise in the relevant business or industry."[54] Due to this additional part of the definition, SOEs that are not operated via market-based financial decisions pertinent to the relevant industry or business will be taken issue with by a complaining party as being non-compliant with the rules. From a competition policy standpoint, the obligation of commercial considerations appears to be pertinent to the requirement for SOEs that operate commercial activities to earn rates of return that are comparable to that of private enterprises, and consequently prevent any profit-earning that enables cross-subsidization for loss-making activities.

Another obligation playing a critical role in incorporating the principle of competitive neutrality in the SOE chapter is the commitment to ensure non-discriminatory treatment to like goods and services. The obligation is essentially a national treatment obligation, which made its way into the negotiations to address the concerns of foreign enterprises that are operating in the market that is home to a SOE and in the markets of other parties that compete against the SOE for purchase or sale of goods and services. The expression describing the non-discriminatory treatment obligation in the SOE chapter is basically the same as those provided in various trade agreements. However, the difference lies in the broader scope of transaction that the obligation applies. In other words,

---

[51] The relevant phrase in Article XVII(b) of GATT states: "The provisions of sub-paragraph (a) of this paragraph shall be understood to required that such enterprises shall, having due regard to the other provisions of this Agreement, make any such purchases or sales solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, …"

[52] There seems to be an evolution in the application of the "commercial considerations" in U.S. FTAs. It is notable that in the Korea-U.S. FTA, the commercial considerations obligation was attached only to designated monopolies in addition to the non-discriminatory treatment obligation (Article 16.2), whereas the provision on state enterprises only refers to the obligation of non-discriminatory treatment (Article 16.3). In the subsequent Singapore-U.S. FTA, the provisions on Government Enterprises (Article 12.3.2) provides for obligations of both non-discriminatory treatment and commercial considerations.

[53] WTO Appellate Body Report, *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain*, WT/DS276/AB/R, adopted 27 September 2004, para. 140.

[54] TPP Agreement, Article 17.1.

the obligation to provide equivalent treatment applies when an SOE both sells and purchases goods and services to enterprises (both private and state-owned) of another party as member of the trade agreement and of non-parties to the trade agreement, and to investments that are present in the SOE's home territory.

While the provision excluding government procurement from application of this chapter does not discipline governments in their public procurement operations,[55] this provision does discipline SOEs when they purchase goods or services so that they do not provide any favorable treatment to any particular supplier. As a consequence, in-house provision of goods or services or any other form of private contract will be subject to disputes if any complaining party should take issue with such practice.

In this sense, the non-discriminatory treatment obligation in the SOE rules embodies the elements of regulatory neutrality and competitive procurement among the priority areas of competitive neutrality. While procurement policies and procedures should be competitive and non-discriminatory, any legal or regulatory treatment should be equal for both public and private businesses, such as in granting building permits, environmental regulations, or access to land and equipment.

4.2.2 Non-Commercial Assistance (NCA)

The integration of competition policy rules and subsidy rules in the TPP SOE chapter appears to be the consequence of a practical solution to address the concerns of major players in the international trade community that mere adoption of non-discriminatory treatment obligations would not be sufficient to resolve all the issues incurred by the preferential treatment of SOEs by governments.[56] Various forms of government assistance provided to SOEs inevitably distort fair competition against private enterprises by enabling SOEs to compete on non-commercial terms in global markets.

The TPP SOE chapter defines "non-commercial assistance" to mean "assistance to a state-owned enterprise by virtue of that state-owned enterprise's government ownership or control."[57] This provision also provides for a non-exhaustive list of various forms of "assistance" in the form of "direct transfer of funds" under the meaning of the SOE chapter, which includes grants, loans and other types of financing provided on non-commercial terms, or equity capital, and goods or services (other than general infrastructure) that are also provided on non-commercial terms. These forms of assistance are quite similar to the types of subsidies that are defined in the WTO SCM Agreement.[58] The provisions on non-commercial assistance also cover subsidies for services, which is an area that is not yet disciplined by the WTO subsidy rules.

---

[55] TPP Agreement, Article 17.2.7: "This chapter shall not apply to government procurement".

[56] Fluery, Julien Sylvestre and Jean-Michel Marcoux. 2016. "The US Shaping of State-Owned Enterprise Disciplines in the Trans-Pacific Partnership", *Journal of International Economic Law* 19(2), at 459.

[57] TPP Agreement, Article 17.1. The term "by virtue of" is understood to refer to the "specificity" of the government assistance provided on non-commercial terms.

[58] WTO SCM Agreement, Article 1.1(a). However, it should be noted that as to whether the TPP SOE disciplines have deliberately omitted from specifying other forms of assistance, such as "foregone revenue"

An important condition for disciplining non-commercial assistance is the existence of "adverse effects" to the interests of another party, or "injury" to the domestic industry of another party.[59] As with the WTO subsidy rules, the complaining party has the burden of proof to provide evidence that the adverse effects or injury have been caused by the non-commercial government assistance. A notable difference, however, is that while the SOE chapter uses the same term "adverse effects" that is used in the WTO SCM Agreement, the substance of "adverse effects" in the SOE chapter is actually identical with the sub-category of "serious prejudice" under the category of "adverse effects" within the meaning of the SCM Agreement. Under the SOE chapter, various types of adverse effects include the displacement or impediment of imports or sales, significant price undercutting, price suppression, price depression, or lost sales, which are all elements of "serious prejudice" under the SCM Agreement. As a consequence, the WTO jurisprudence on serious prejudice within the meaning of the SCM Agreement and related causation analysis will be applicable to the SOE provisions.

It is also notable that the discipline on "pass through" subsidies has been incorporated in the SOE chapter, presumably in response to future cases of privatization of public enterprises. The NCA provision in the SOE chapter addresses both the direct and indirect provision of non-commercial assistance, and detailed explanation is provided in the relevant footnote that "indirect provisions" includes the "situation in which a Party entrusts or directs an enterprise that tis not a state-owned enterprise to provide non-commercial assistance."[60] The past WTO jurisprudence on indirect subsidization has actually not been quite effective in disciplining government assistance provided in the event of restructuring of private or public enterprises.[61] The inclusion of discipline on indirect government assistance would be a prerequisite considering the trend towards privatization of public enterprises, in particular the functions that conduct commercial activities in competition with other private businesses.

4.2.3 Transparency

The third obligation is the transparency requirement, under which member governments must disclose information on their SOEs, including government ownership structures, financial operations, any regulatory exemptions or government assistance. Basically, the SOE chapter has in place reporting requirements to enable other TPP countries to observe whether SOEs are benefiting from government subsidies or regulatory tolerance. The transparency provisions would also disclose whether SOE decisions are made on a commercial basis, or based on strategic or social reasons. It is important to note that the transparency obligation is also subject to the dispute settlement procedures of the TPP, implying that non-compliance with the commitments to disclose information on SOEs and their operation may result in a formal litigation against the non-compliant party.

(i.e. tax credits), there is no clear guidance for interpretation and application. This issue is explained in more detail in the following part C on legal issues in applying TPP SOE rules.

[59] TPP Agreement, Articles 17.7 and 17.8.

[60] TPP SOE Chapter, Article 17.6 and footnote 18.

[61] For WTO jurisprudence on indirect subsidization, refer to *US-Countervailing Duty Investigation on Dynamic Random Memory Semiconductors* (WT/DS296), *EC-Countervailing Measures on Dynamic Random Memory Semiconductors* (WT/DS299).

The transparency obligation in the SOE chapter reflects the importance of operating transparent cost structures for SOEs under the principle of competitive neutrality. This requirement ensures that the remuneration of public service obligations is adequately made based on identification of costs associated with fulfilling public service obligations in a transparent manner. According to competitive neutrality principles, subsidies granted to SOEs for performing their public service functions should be neither over- nor under-compensated.

4.2.4 Exceptions and Non-Conforming Measures

There are various exemptions and carve outs that are incorporated in the SOE chapter in various forms, including built-in exception clauses and footnotes in the text of the SOE chapter, specific Annexes attached to the text that specify derogations for certain TPP parties, and the voluminous Annex that lists the non-conforming activities of each TPP party.

An important exception to the disciplines on non-commercial assistance applies where SOEs supply domestic services within their home territory.[62] This implies that such domestic services as postal or railway services are not subject to the disciplines, providing quite a large carve out for the TPP members. However, if such services are expanded abroad and supplied across the border, they become subject to the disciplines, and will be ruled on whether the services that have received non-commercial assistance have "displaced or impeded" the sales of like services provided by a competitor, or significantly undercut or depressed the price of a like service supplied by another party.

Another exception clause in the SOE chapter with significant impact is the exemption of SOE activities from the obligation of commercial considerations for the purpose of fulfilling their public service mandate.[63] "Public service mandate" is defined as a government mandate under which SOEs supply domestic public service, such as the distribution of goods and supply of general infrastructure services.[64]

A related carve out from the scope of application of the SOE chapter is the exception for "services supplied in the exercise of governmental authority."[65] For the purposes of this chapter, the SOE chapter refers to the meaning provided in the Financial Services Annex of the GATS. The Annex provides detailed explanation of the term, including monetary or exchange rate policies by the central bank or monetary authorities, social security or public retirement plans, or other SOE activities that are conducted with government guarantee or financial resources.[66]

---

[62] TPP Agreement, Article 17.6.4 provides that: "A service supplied by a state-owned enterprise of a Party within that Party's territory shall be deemed to not cause adverse effects".

[63] TPP Agreement, Article 17.4.1(a): "Each Party shall ensure that each of its state-owned enterprises, when engaging in commercial activities, acts in accordance with commercial considerations in its purchase or sale of a good or service, except to fulfill any terms of its public service mandate that are not inconsistent with subparagraph (c)(ii)" *(emphasis added).*

[64] TPP Agreement, Article 17.1 and footnote 6.

[65] TPP Agreement, Article 17.2.10.

[66] GATS, Annex on Financial Services, Article 1(b).

There are other exception clauses that provide for comprehensive non-application of the SOE disciplines for such measures as monetary and exchange rate policy, regulation or supervision of financial service suppliers, resolution of failing financial institutions, sovereign wealth funds, independent pension funds, and government procurement.[67] Other important exceptions relate to the adoption of temporary measures to respond to national or global economic emergency, and the non-application of SOE obligations for entities that earn less than the threshold amount of 200 SDRs.[68] In addition to these exceptions, each of the TPP parties has listed up entities, scope of non-conforming activities, and the obligations they seek exemption in their annexes.[69]

The exception clauses and carve outs to the TPP SOE rules can be understood from the context of competitive neutrality. The principles of competitive neutrality address situations where entities operating in an economic market are subject to undue competitive advantages or disadvantages. They specifically apply to situations where public and private entities operate in 'mixed markets', where state and private entities co-exist. However, they do not apply where public authorities exert their sovereign right to regulate in deciding that certain goods and services shall be provided by the public sector only. Provided that there is sufficient transparency about the government decision and public interest that has motivated it, exceptions for public policy objectives are generally not considered to be a departure from competitive neutrality.[70] Furthermore, there is general recognition of the existence of situations where insistence on strict competitive neutrality is not appropriate as it may hamper the achievement of societal goals, such as for dealing with crisis situations and bank bailouts.[71]

4.2. Legal Issues and Challenges in Applying TPP SOE Rules

4.3.1 Scope of Non-Commercial Assistance

As mentioned previously, the scope of NCA in the TPP SOE chapter appears to differ from the scope of subsidies covered by the WTO SCM Agreement. There may be differing opinions as to whether the non-exhaustive list of NCA provided in the SOE chapter implicitly also includes NCA in the form of fiscal incentives. Tax neutrality is actually an important element for ensuring competitive neutrality between public and private entities in the market. However, it can also be observed that most of the tax credits that are provided by the government to business entities involve projects for building safety facilities, facilities for improving energy efficiency or environmental preservation, or moving business complexes to more remote regional areas. As such, the non-coverage of such fiscal incentives that are closely related to pursuing public and societal goals may have been deliberate and intended. In the end, the ultimate clarification will

[67] TPP Agreement, Articles 17.2.2-17.2.7.
[68] TPP Agreement, Articles 17.13.1 and 17.13.5.
[69] TPP Agreement, Annex IV. Many of the non-conforming activities listed in the annexed schedules include exemptions from non-commercial assistance and non-discriminatory treatment obligations in the areas of energy (oil and gas), utilities (electricity, telecommunications, transportation), finance (development banks, infrastructure banks), and protection of indigenous persons, underdeveloped areas or small and medium-sized enterprises.
[70] OECD (2012b), See above n 40, at 15.
[71] OECD (2009), See above n 39, at 12.

have to be provided by the TPP dispute settlement body in providing clear guidance on how definition applies.

Analysis of NCA actually requires comparison with the legal structure and key elements of the WTO SCM Agreement. Under the SCM Agreement, a subsidy is deemed to exist if a "government or a public body" confers any type of subsidy in the form of "financial contribution" that falls under Article 1.1(a)(1),[72] or income or price support within the meaning of Article 1.1(a)(2), and a "benefit" is conferred to the recipient through subsidization. Furthermore, the subsidy is subject to the disciplines only if it is shown to be "specific" to an enterprise, industry, or group of enterprises. These four elements in the SCM Agreement in determining whether a subsidy exists have been subject to in-depth scrutiny in numerous disputes involving subsidy measures by member governments.

In the TPP SOE chapter, all the four elements are incorporated, but they are adapted to the specific case of SOEs and related government assistance, consequently resulting in several noticeable differences. First of all, the scope of coverage of "government or any public body" as the provider of subsidies under the SCM Agreement was rather unclear on whether SOEs would pertain to the definition of "any public body." On the other hand, the SOE chapter disciplines NCA provided by both the government and SOEs, thereby clearly bringing SOEs into the scope of coverage of the disciplines. Secondly, the types of NCAs are similar – but not exactly identical – to the types of measures constituting financial contribution in the SCM Agreement. As mentioned above, among the four types of "financial contribution" within the meaning of Article 1.1(a)(1) of the SCM Agreement, the SOE chapter only refers specifically to the first and third type of financial contributions, but has left out the second type – "government revenue that is otherwise due foregone or not collected" – from the non-exhaustive list. Given that, due to the similarity of rules and concepts, the SCM Agreement would provide the basis for interpretation of the SOE provisions, it may be reasonable to make a rebuttable presumption that NCA in the form of fiscal incentives may not be as strictly subject to the SOE disciplines as the other specifically mentioned types of NCA. As regards the third element of "benefit", there have been quite a number of WTO disputes surrounding the proper application of the benefit analysis under the SCM Agreement. However, the concept of "benefit" seems to be inherent in the term "non-commercial assistance" in the SOE chapter, since the term itself shows the lack of commercial reasonableness in the provision of the government assistance. Therefore, unlike the WTO subsidy rules, the application of the benefit analysis may not be as contentious under the SOE rules. Lastly, the "specificity" test under the SCM Agreement more recently involves the determination of whether the subsidies are *de facto* specific, which involves examination and evidence of the actual proportion of subsidization to the targeted recipient. In this regard, the SOE chapter provides a clear-cut definition of "by virtue of government ownership or control" as referring not only to the explicit limit of access to assistance to SOEs, but

[72] The types of subsidies that fall under SCM Agreement Article 1.1(a)(1) are financial contribution in the form of: (i) direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees); (ii) government revenue that is otherwise due foregone or not collected (e.g. fiscal incentives such as tax credits); (iii) provision of goods and services other than general infrastructure, or purchase of goods; (iv) government payment to a funding mechanism, or entrustment of direction to a private body to carry out government functions listed in (i)-(iii) above.

also the predominant use or amount of assistance that has resulted in disproportionately large amounts to state-owned enterprises.[73]

Figure 1. Comparison of Elements for Assistance in SCM Agreement and SOE Chapter

Elements	WTO SCM Agreement	TPP SOE Chapter
Provider of assistance	"by government or any public body"	Discipline over NCA provided by government and SOE
Types of assistance	Financial contribution in the form of: (i) direct transfer of funds (grants, loans, equity infusions) or potentially direct transfer of funds (loan guarantees); (ii) foregone government revenue; (iii) provision of goods and services other than general infrastructure, purchase of goods; (iv) entrustment or direction of private body to carry out government function	(i) Direct or potentially direct transfer of funds, such as grants or debt forgiveness, loans, loan guarantees, other financing on non-commercial terms, or equity capital based on unusual investment practice; (ii) provision of goods or services other than general infrastructure on non-commercial terms
Benefit	Various benefit analysis and tests applied on a case-by-case basis by WTO adjudicating bodies	Inherent existence of "benefit" in the term "non-commercial" assistance
Specificity	*De jure* and *de facto* specificity	"by virtue of government ownership or control": (i) explicitly limit access to the assistance to SOEs; (ii) assistance which is predominantly used by SOEs; (iii) provide disproportionately large amount of assistance to SOEs; (iv) favor SOEs though use of discretion in providing assistance

4.3.2 Scope of "Adverse Effects" and Causality Analysis

Both the SCM Agreement and SOE chapter require evidence that the "adverse effects" have been caused by the government assistance in order for the assistance measure to be subject to the disciplines. However, despite the identical terminology, the scope of "adverse effects" in the TPP SOE provisions is far narrower than that of "adverse effects" in the SCM Agreement. Rather, the

[73] TPP SOE Chapter, Article 17.1.

elements and substance of the "adverse effects" in the SOE chapter are more identical to the "serious prejudice" element of "adverse effects" within the meaning of the SCM Agreement.[74]

According to current WTO jurisprudence on "serious prejudice" of the SCM Agreement, it is always up to the complaining party to demonstrate that a specific subsidy causes serious prejudice or a threat of serious prejudice. Serious prejudice is present if one of the four types is demonstrated, which are mainly focused on the trade effects of subsidization.[75] To formulate a successful claim, the presence of one of the listed volume or price market phenomena should be demonstrated, and these should be shown to be the effect of the subsidy. The magnitude of the subsidies can be helpful to prove the claim, but it is not necessarily required to quantify the precise subsidy amount. As such, the requirement to effectively demonstrate adverse trade effects is quite a high hurdle, both in legal and economic terms, to establish an actionable subsidy claim.[76]

However, the SOE chapter differs from the SCM Agreement in that not all the elements of "serious prejudice" have been incorporated into the SOE provisions. TPP negotiators seem to have selected only those provisions that are pertinent for the effective operation of the disciplines. In other words, there is no provision for the "threat of serious prejudice" in the SOE chapter, which takes into account the possibility of serious prejudice that does not yet exist, but is imminent such that it will materialize in the near future. Although this is actually a difficult legal hurdle to be overcome, the exclusion of these elements has made the scope of "adverse effect/serious prejudice" in the SOE chapter narrower than that of the SCM Agreement.

Among the elements of "serious prejudice" within the meaning of the SCM Agreement, the "displacement or impedance" to third-country markets is understood to require a lower threshold than compared to the "displacement or impedance" of imports into the subsidizing country's market. This is due to the condition attached, which states that it refers to "any case in which it has been demonstrated that there has been a change in relative shares of the market due to the disadvantage of the non-subsidized like product."[77] This means that for a complainant to invoke this lower threshold, their own like products should not be subsidized, which is an unlikely situation in a market where public and private entities compete. The issue is whether SOEs have received government assistance on more favorable terms than that provided by the market. Consequently, this condition has been omitted from the SOE provisions, as it would have effectively barred the use of this provision if the complainant's like products or services were subsidized.

---

[74] WTO SCM Agreement, Article 6.3.

[75] The four types are: displacement or impediment of imports into the market of the subsidizing Member; displacement or impediment of exports from a third-country market; significant price undercutting or significant price suppression, price depression, or lost sales; increase in the world market share of the subsidizing Member.

[76] Coppens, Dominic (2014), WTO Disciplines on Subsidies and Countervailing Measures: Balancing Policy Space and Legal Constraints, Cambridge University Press, p. 147-149.

[77] SCM Agreement, Article 6.4.

Despite the narrower scope of "adverse effects" in the SOE disciplines, the causality analysis required for the SOE chapter does not seem to be more burdensome for the complaining party as compared to the case under the WTO SCM Agreement. A comparison of the elements that are required for demonstrating the occurrence of "displacement or impeding" of trade volume and "price undercutting" are identical in both SOE and SCM rules.[78] If anything, the baseline that can be used for comparing prices based on the level of trade appears to be broader in the case of SOE rules, by providing that when direct comparison of transactions is not possible, price undercutting may be demonstrated "on some other reasonable basis, such as, in the case of goods, a comparison of unit values."[79] Although there is only a slight difference in wording, this phrase opens up the possibility of reliance on other units of comparison, for example for the transaction in services. On a more general note, since the scope of transactions under the TPP SOE rules involves not only transactions in the market of the subsidizing party, but those of the other Party and third country non-TPP parties, there may be available evidence of market distortions, hence making the case for causality less difficult for the complaining party in dispute settlement proceedings.

4.3.3 Application of Rules to SOEs Engaged in 'Mixed' Activities

As mentioned above, the TPP SOE rules discipline only SOEs that engage in commercial activities. In other words, SOEs whose primary role is to provide public services are not covered by the TPP disciplines. This is based on the recognition that the provision of public services by SOEs serves an important policy objective where market failure problems cannot be solved by mere private participation. One of the rationales for pursuing competitive neutrality is to let governments serve their role as regulators to ensure economic entities play by the rules, while also ensuring that public service obligations are met.[80] The role of SOEs as a supplier of public service mandates are recognized, for which the intervention of government is required to correct market failures and serve essential societal goals.

However, a question arises with regard to SOEs that are engaged in both commercial and non-commercial activities. How do the TPP SOE rules apply if the lines between commercial and non-commercial business operations are not clearly demarcated? How do you ensure that the commercial activities of such SOEs are operated according to the competitive neutrality principles if they are blurred with the profits earned from non-commercial activities? This is the actual reality that many SOEs face around the world.

---

[78] Refer to Articles 6.4 and 6.5 of the WTO SCM Agreement, and Articles 17.7.2 and 17.7.4 of the TPP SOE Chapter. According to the relevant provisions in the SCM Agreement, the "displacement or impeding" of trade volumes requires the demonstration of a "change in relative shares of the market", which in turn includes: (a) increase in the market share of the subsidized product; (b) market share of the subsidized product remains constant in circumstances in which, in the absence of the subsidy, it would have declined; (c) market share of the subsidized product declines, but at a slower rate than would have been the case in the absence of the subsidy. As for "price undercutting", it must be demonstrated "through a comparison of prices of the subsidized product with prices of a non-subsidized like product", with comparison made "at the same level of trade and at comparable times, due account being taken at any other factor affecting price comparability". When direct comparison is not possible, existence of price undercutting may be demonstrated "on the basis of export unit values".

[79] TPP SOE Chapter, Article 17.7.4.

[80] OECD (2012b), See above n 40, at 9.

The studies on competitive neutrality reveal the difficulty of drawing a distinct demarcation line between "commercial" and "non-commercial" entities and activities. To avoid addressing the problem, the recommendations for compliance with competitive neutrality principles start from the assumption that "commercial activities" denote activities in the market place that do not constitute public policy functions, and "commercial entities" as entities not tasked with carrying out policy functions.[81] The policy proposals to implement competitive neutrality do not go so far as to define what constitutes 'valid' or legitimate public policy functions, but simply state that departures from competitive neutrality may be reconciled where public interest objectives are at stake. In fact, as mentioned above, the political rationale for pursuing competitive neutrality is to ensure that public service obligations are met, while ensuring that economic entities act in accordance with competitive rules.

As a solution to this challenge, the OECD recommends the restructuring of SOE business operations so that SOE activities that compete with private entities in the market are structurally separated, to be carried out by an independent legal entity operated at arm's length from the government. However, such a remedy may not always be feasible in practice, nor economically efficient. While the process of structural separation would lead to strengthened competitive neutrality in the market place, the benefits may not always outweigh the costs. In some types of economic activity, structural separation of commercial and non-commercial activities may not be feasible, mainly in cases where production processes rely on the same physical or human capital, or where certain levels of public service needs to be maintained to correct market failures or fulfill public policy objectives. In such cases, it may be more economically efficient to maintain the business activities that are based on the economies of scale.[82]

At the same time, it is important to ensure that SOEs are provided adequate compensation for fulfilling their public service obligations. This would prevent the SOE from engaging or expanding their commercial activities in the first place, or at least prevent cross-subsidization of commercial activities from profits earned from the non-commercial functions. To this end, cost structures of public functions would need to be transparent through monitoring and oversight by independent agencies.

As such, addressing such challenges would have to be based on arduous efforts on the part of sovereign governments to identify the challenges faced by their SOEs and to take into account their distinct regulatory environments. However, pursuit of structural reforms for the separation of commercial activities from the existing operation structure of SOEs for the sake of strictly pursuing competitive neutrality principles would not be desirable. Competitive neutrality does not necessarily require entities that serve public policy objectives to be subject to strict competition rules as with those commercial entities. The incorporation of exceptions to the SOE commitments for fulfilling legitimate public service mandates reveals some level of consensus on this matter. Ultimately, it may be up to the government to exercise a significant degree of self-restraint to preserve a competitive business environment while maintaining SOES that serve public policy functions.

---

[81] *Ibid.*, at 18.
[82] *Ibid.*, at 30.

5. Conclusion

The significance and value of the SOE rules in the TPP lie in the revolutionary attempt to incorporate competition principles into trade rules through integration of rules that discipline anti-competitive practices and government subsidization that distort competition in trade and investment. While the effectiveness of the new rules might be undermined by the various carve outs that take into account the public policy objectives of governments, some credit may be warranted for efforts to narrow them down as a result of balancing with the need for some flexibility in trade deals.

From the competition policy perspective, the rules on SOE in TPP seem to be a 'qualified' success, particularly in terms of introducing the principle of "competitive neutrality" in trade agreements. The elements of competition policy appear to have been incorporated into the trade rules with the desired binding force to enforce what has been put into law. The major obligations in the TPP SOE chapter requiring SOEs to make commercial considerations when engaging in commercial activities and to ensure non-discriminatory treatment when purchasing and selling goods and services are all pertinent to the basic principles of competitive neutrality for disciplining the anti-competitive practices of SOEs. The TPP SOE disciplines on non-commercial assistance, on the other hand, while they take a similar form as with the WTO subsidy rules, are also critical to ensure that competitive neutrality is achieved in terms of tax and debt neutrality. The NCA provisions will also prevent SOEs from cross-subsidization practices of commercial activities through their revenues from non-commercial activities, which is an important source of distortion in open competition markets. However, the various exceptions and specific carve outs that exempt TPP parties from commitments to strictly apply the principles of competitive neutrality risk undermining the significance and impact of the SOE rules as a revolutionary attempt to rule-making at a more multilateral level.

Implications can be derived from this new attempt to combine the "hard-law" mechanism of WTO trade rules and the more "soft-law" mechanisms of traditionally domestic competition rules. In today's world where issues which were considered to apply only in the domestic sphere are increasingly having transnational effects, more revolutionary approaches to rule-making may be in need to respond to changes in the global economy. On the other hand, present areas where "hard-law" approaches were thought to be the norm, more "soft-law" approaches may be needed, such as to provide a breakthrough in deadlocked multilateral negotiations.

Other implications can be drawn from this success case of issue-based plurilateral framework of negotiations. Whereas consensus could not be achieved on bringing general competition policy into trade rules, important competition issues relevant to the business practices of state enterprises were able to garner support for separate rule-making. As already evident in many areas, such as in IT and environmental goods, and even in the area of services trade, such issue-based trade agreements seem at the moment the most practical way to make a step forward out of the stalemate in multilateral negotiations.

Another lesson that can be drawn from the TPP SOE chapter is the importance of "flexibilities" in negotiated outcomes among parties. International trade agreements are basically negotiated agreements among parties interested in disciplining themselves to make their trading environment beneficial for everyone. At the same time, each party comes to the negotiating table with different political, economic, and social interests as representatives of their national sovereign governments. Without any "carve outs" for accommodating legitimate policy space, especially for developing member countries, trade arrangements will lack the legitimacy required for functioning as an effective international trade discipline. Various methods for providing "flexibilities" in trade agreements will help parties to achieve the desired effects of the trade disciplines without undermining the fundamental objectives of the new trade rules.

References

Burdekin, Anderson, Robert D. and Anna Caroline Muller. 2015. "Competition Law/Policy and the Multilateral Trading System; A Possible Agenda for the Future." E15 Expert Group on Competition Policy and the Trade System – Think Piece, International Center for Trade and Sustainable Development (ICTSD) and World Economic Forum.

Fleury, Julien Sylvestre and Jean-Michel Marcoux. 2016. "The US Shaping of State-Owned Enterprise Disciplines in the Trans-Pacific Partnership." *Journal of International Economic Law*, 19(2).

Gadbaw, R. Michael. 2016. "Chapter 7: Competition Policy." In Jeffrey J. Schott and Cathleen Cimino-Isaccs eds. Assessing the Trans-Pacific Partnership, Volume 2: Innovations in Trading Rules. PIIE Briefing 16-4. Peterson Institute for International Economics.

Hilmer, F., M. Rayner, G. Taperell. 1993. "National Competition Policy." Canberra: Australian Government Publishing Service.

Hilmer, Frederick G. 1995. "Competition Policy: Underlying Ideas and Issues." University of Western Australia, Discussion Paper 95.18.

Kowalski, P. *et al*. 2013. "State-Owned Enterprises: Trade Effects and Policy Implications." OECD Trade Policy Papers, No. 147. Paris: OECD, available at: http://dx.doi.org/10.1787/5k4869ckqk7l-en.

Matsushita, Mitsuo, Thomas J. Schoenbaum, Petros C. Mavroidis. 2006. The World Trade Organization: Law, Practice and Policy (second edition), Oxford University Press.

Miner, Sean. 2016. "Chapter 8: Commitments on State-Owned Enterprises." In Jeffrey J. Schott and Cathleen Cimino-Isaccs eds. Assessing the Trans-Pacific Partnership, Volume 2: Innovations in Trading Rules. PIIE Briefing 16-4. Peterson Institute for International Economics.

OECD. 2009. "State Owned Enterprises and the Principle of Competitive Neutrality." DAF/COMP(2009)37. Directorate for Financial and Enterprise Affairs, Competition Committee, Paris: OECD.

OECD. 2012a. "Competitive Neutrality: A Compendium of OECD Recommendations, Guidelines and Best Practices." Paris: OECD, available at: http://www.oecd.org/daf/ca/50250955.pdf.

OECD. 2012b. "Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business." Paris: OECD.

OECD. 2015. "OECD Guidelines on Corporate Governance of State-Owned Enterprises." 2015 Edition. Paris: OECD, available at: http://dx.doi.org/10.1787/9789264244160-en.

Perez Motta, Eduardo. 2016. "Competition Policy and Trade in the Global Economy: Towards an Integrated Approach." E15 Expert Group on Competition Policy and the Trade System – Policy

Options Paper, E15 Initiative. Geneva: International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum.
Rennie, M. and F. 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. Paris: OECD.

Sauve, Pierre and Marta Soprana. 2015. "Learning by Not Doing: Subsidy Disciplines in Services Trade." E15 Task Force on Rethinking International Subsidies Disciplines – Think Piece, International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum.

Yun, Mikyung. 2016. "An Analysis of the New Trade Regime for State-Owned Enterprises under the Trans-Pacific Partnership Agreement." *Journal of East Asian Economic Integration*, Vol. 20, No. 1.