

## DOES THE NATIONAL INTEREST MATTER? A CASE STUDY OF A CROSS-BORDER MERGER

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### Abstract

In cross-border mergers, matters of national interest often emerge. In this paper, we examine the question as to what constitutes the national interest, and whether it affects the probability of a merger receiving regulatory approval. To illustrate, we examine the takeover of the Australian resources company Western Mining Corporation.

**Keywords:** Cross-border mergers, legitimacy, national interest

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### 1. Introduction

When a merger is initiated, the actions of three entities become important; the bidder, the target, and the regulator who approves or rejects the merger. When assessing a bid, the target's shareholders usually only consider whether the offer price exceeds an independent valuation of the firm. Other issues, for example those relating to corporate governance, are rarely considered. Corporate governance is one of a wider class of issues, which, although not price relevant, are relevant to other entities including national governments. In cross-border mergers, such issues may become matters of the national interest.

But what is the national interest? The national interest is a term which is often cited in cross-border mergers, particularly mergers involving national security and other strategic interests. However, precise definitions of the national interest are difficult to find. It is a discretionary term, deliberately vague to allow the rejection of mergers deemed contrary to the national interest. In cross-border mergers, the national interest becomes important because a successful bidder will typically operate and report in two different countries. This divergence between the operations and the ownership may weaken corporate accountability and liability and, as a consequence, the national interest.

In the recent acquisition of the Australian mining company, WMC Resources Limited (WMC), the bid by the Swiss-based Xstrata plc, received an unusually high degree of comment. Two regulators, the Australian Competition and Consumer Commission (ACCC) and the Foreign Investment Review Board

(FIRB), approved the bid. The ACCC is the Australian competition regulator while the FIRB, the principal regulator for cross-border mergers, has the power to reject a merger in the national interest. Ultimately, Xstrata was not successful. Its bid was exceeded by the bid of a diversified mining company, BHP Billiton (BHP-B), headquartered in Australia, but technically a British company. It was the bid of Xstrata, however, that evoked the most discussion of the national interest.

WMC owned the world's largest reserve of uranium at Roxby Downs in South Australia. Uranium is a special commodity in Australia. The mining and distribution of uranium is always a matter of high national interest. It was the mining of uranium in 1975 that initiated the Foreign Acquisitions and Takeovers Act, and it is uranium that is specifically listed as a sensitive sector by the FIRB. Xstrata had embarked on a substantial acquisition program in 1997 and its corporate history was characterised by aggressive acquisitions and a number of questions relating to governance and asset depreciation. Its bid for a strategic national resource was then assured to provide a powerful test of what constitutes the national interest. This test is the basis of this paper.

In this paper, we consider the role of the national interest in cross-border mergers. Most of this discussion is in Section 2. In Section 3, we review the takeover bid for WMC by Xstrata, the associated national interest issues and the decisions of the main regulator, the FIRB. Section 4 concludes the paper.

## 2. The National Interest in Cross-Border Mergers

In August 2006, the Italian government opposed the merger of the Italian motorway firm Autostrade and its Spanish counterpart Abertis. The decision to reject the merger was for reasons of the public interest, in particular that the merger may induce instability in Italian motorway operations, reduce investment in Italy and affect quality and safety standards (*see endnote 1*). The decision to reject the Autostrade-Abertis merger is an example where regulators intervene in the national interest. In general, however, the national interest is seldom defined. It is a discretionary concept, usually considered on a case-by-case basis. The report of the Australian Foreign Investment Review Board (*see endnote 2*) (p.8) exemplifies this point. "The Act empowers the Treasurer to prohibit an acquisition if he is satisfied it would be contrary to the national interest. The national interest, and hence what would be contrary to it, is not defined in the Act. Instead, it confers upon the Treasurer the power to decide in each case whether a particular proposal would be contrary to the national interest." The Australian national interest, like those of most countries, is difficult to define.

What then is the national interest? In the context of cross-border mergers, the national interest refers to the ability of a national government to exercise control over strategic interests, to exercise control over the allocation and distribution of resources, and to exercise control over the regulation of companies operating within its borders. Any cross-border merger, which dilutes the government's ability to exercise these controls, can be regarded as diluting the national interest. The national interest is more precisely defined by considering a hierarchy of five levels

- (1) National security
- (2) Strategic interests
- (3) Competition policy
- (4) Employment
- (5) Corporate governance, environmental, health and safety standards

This hierarchy is implicit in the discussions of the national interest for many countries; for example, the United States, the individual countries of the European Union, Japan, and Australia. National security is the most commonly cited and legislated national interest, but all of the five levels of national interest are relevant in some sense in cross-border mergers. The five levels are considered *seriatim*.

### National Security

National governments regard sovereign control over national security as the highest priority. This principle is enshrined in the legislation or review procedures of most countries. In the United States, for example, the 1988 Exon-Florio statute grants the President the authority to take appropriate action to suspend or prohibit foreign acquisitions, mergers or takeovers of

US businesses that threaten to impair the national security. Article 223 of the Treaty of Rome, which established the European Economic Community, states that European member nations may take measures "necessary for the protection of the essential interest of its security which are connected with the production or trade of arms munitions and war material." (*see endnote 3*).

While no country has legislation equivalent to Exon-Florio, all countries have established review procedures, which allow for the rejection of cross-border mergers on the basis of national security. All require case-by-case evaluations for acquisitions in the defence and armaments industries. Some provisions are quite specific; for example, in the United Kingdom, British Aerospace PLC and Rolls Royce PLC restrict the number of foreign-held shares at any one time to 29.5% of the ordinary voting equity. The importance of national security has been reaffirmed since September 2001, with many countries tightening legislation. The United States Exon-Florio statute is being amended to permit scrutiny of transactions involving entities owned or controlled by foreign governments, the German government tightened rules for foreign ownership of defence-related enterprises in 2004 and 2005, and Russia is drafting new legislation to protect strategic sectors from foreign ownership (*see endnote 4*). Clearly, September 11 2001 has catalysed the national interest.

Does national security matter in cross-border mergers? There is some evidence that it does. While the President of the United States has only blocked one foreign takeover since 1988 for reasons of national security, 15 cases have been investigated using Exon-Florio, and other relevant acquisitions have received considerable scrutiny, for example, the 2005 acquisition of United Defense Industries by BAE Industries of the UK, and the 2005 acquisition of the UK company Peninsular and Oriental Steam Navigation Co. by Dubai Ports World. There is also evidence that national security matters for cross-border mergers in other countries. India blocked bids by two Chinese companies to extend their influence in information technology (Huawei Technologies) and container terminals (Hutchison Port Holdings) on the basis of national security, and the German legislation of 2004 was in response to the foreign acquisition of the submarine builder Howaldtswerk-Deutsche Werft. The dilution of control over national security evokes strong political and regulatory responses.

### Strategic Interests

A second level of national interest pertains to strategic interests unrelated to defence and armaments. These strategic interests principally involve resources, public utilities and the financial system. Many countries refer to sensitive sectors in their foreign investment legislation. The 1989 Foreign Acquisitions and Takeovers Regulations Act of Australia, for example,

lists sensitive sectors as media, telecommunications, transport, and extraction of uranium in addition to defense related sectors.

Like national security, strategic interests are often examined in cross-border mergers. There are many examples (*see endnote 5*). In the resources sector, the Chinese oil company CNOOC withdrew its bid for the US oil company Unocal after concerns were raised relating to the long-term energy security of the US. Russia has capped foreign capital participation in its oil and mineral concessions at 49%, and a number of South American countries have imposed retrospective conditions on foreign oil companies. In public utilities, Spain regulated to reject a bid by the German company EON for the Spanish electricity group Endesa, and China rejected a bid by the German manufacturer Siemens for a Chinese state-owned electrical equipment manufacturer. In banking, the Italian bank regulator moved to oppose a bid by the Dutch bank ABN Amro for the Italian lender Antonveneta, and Poland challenged an acquisition of a German bank (HVB Group) with Polish operations, by Italy's UniCredito. Strategic interests and national security are analogous. Dilution of control evokes strong political and regulatory responses.

### Competition Policy

Most cross-border mergers are regulated using some form of anti-trust legislation which monitors the effects on competition within industries. In the United States, mergers are regulated by the Federal Trade Commission and the Department of Justice using the 1976 Hart-Scott-Rodino Antitrust Improvements Act, in Europe by the European Commission (EC) under the 2004 EC Merger Regulation (aside from cases where the turnover of the company is at least two-thirds in the individual country) and in Australia by the Australian Competition and Consumer Commission. In each case, the principle of regulation is to prevent anti-competitive behaviour resulting from the concentration of market share. Typically, the focus is on target companies with substantial turnovers; for example in the European Union global turnovers of 5 billion Euros (with 250million within the European Economic Area), in the United Kingdom 70 million pounds, and in Australia by value \$50 million (\$800 million for US investors).

How does competition policy relate to the national interest? Referral of a cross-border merger to the competition regulator protects the national interest for two important reasons. It confers continuity of supply and it confers price stability. The ACCC decision on the acquisition of MIM Holdings by Xstrata PLC illustrates the point. In approving the acquisition, the ACCC (*see endnote 6*) stated that

"The acquisition is unlikely to substantially lessen competition in the national markets for thermal coal and coking coal. The ACCC found that there are a significant number of competing mining companies and that these competitors will constrain prices for

coal. Xstrata's competitors supply both the domestic and international markets and would be able to redirect supply in response to a price increase by Xstrata. Further, the ACCC considered that the global trading and pricing of coal is likely to exercise an effective competitive constraint on Xstrata."

### Employment

In most theoretical discussions of cross-border mergers, there is no reference to employment effects, aside from senior management turnover (*see endnote 7*). In most practical discussions of cross-border mergers, minimising employment effects is critical to the approval of the merger. This divergence between theory and practice shows the limitations of merger valuation when the national interest is ignored. Expectations of job losses as a result of a cross-border merger reduce the probability that a merger will receive regulatory approval. A bidder will mitigate these effects by conceding a role to social issues. In the 1998 merger between the German automaker Daimler Benz A.G and the US automaker Chrysler, social issues were the first discussed when the two CEOs met to discuss the merger (Bruner (2003, p.677). Governance, organisational structure and the integration of the entities were discussed first, and pricing second. The emphasis on social issues was recognition that the merger required approval not just from shareholders, but also from regulators and unions in the United States and Germany.

Article 16 of the European Union's 2005 directive on cross-border mergers, which includes specific provisions on employee participation, illustrates the importance of the role of employees in cross-border mergers (*see endnote 8*). If a cross-border merger is detrimental to employment or employee participation, it weakens the ability of a national government to control employment policy.

### Corporate Governance, Environmental, Health and Safety Standards

A successful bidder in a cross-border merger may be constrained by national interest issues relating to governance, environmental and safety standards. In the takeover of WMC studied in Section 3, the bidder Xstrata was required to provide undertakings that it would conform to Australian laws and regulations relating to the mining, distribution and marketing of uranium. The constraints imposed on Xstrata are constraints that a cross-border bidder can expect when the merger involves national strategic interests. In general, the bidder imports the legal operating environment of the target. The target imports the corporate governance environment of the acquirer (*see endnote 9*). How the national interest is affected depends on how the bidder operates in a new legal environment given its accountability to a regulator in another country.

The divergence between where the company reports and where the company operates becomes the most important issue in assessing the national interest in cross-border mergers. Keynes discussed it this way when discussing the concept of national self-sufficiency (*see endnote 10*)

“The divorce between ownership and the real responsibility of management is serious within a country when, as a result of joint-stock enterprise, ownership is broken up between innumerable individuals who buy their interest today and sell it tomorrow and lack altogether both knowledge and responsibility towards what they momentarily own. But when the same principle is applied internationally, it is, in times of stress, intolerable – I am irresponsible towards what I own and those who operate what I own are irresponsible towards me.”

The sentiment of Keynes is a sentiment which underwrites the argument for greater control of companies which operate within national borders. A national regulator must determine whether the bidder can satisfy the legal operating constraints within the country, given that the bidder does not report to its own securities exchange commission. The regulatory risk is that a successful bidder may not comply with the legal constraints imposed, thereby acting contrary to the national interest.

However, most discussions of the risk in cross-border mergers relate not to regulatory risk, but to the risk of the acquirer. The acquirer minimizes its risks by undertaking due diligence. As Bruner (2003, p.216) asserts, in due diligence, the bidder assesses the legal risk associated with the target in relation to

- (1) pending and potential litigation which may result in adverse judgments;
- (2) conformity to regulation which may result in loss of license to operate; and
- (3) liabilities arising from previous transactions of the target.

The bidder must determine the extent of insurable risks that it imports as a result of the acquisition, and the extent to which these risks are insured. Of particular interest is environmental due diligence. In the United States, a successful bidder is liable for the clean-up of any polluted site that it acquires. Potential environmental liabilities are then an important risk factor. In valuing a target, a bidder must adjust for the legal risks and how those risks are hedged. This is usually achieved by increasing the discount factor on future cash flows. There is some evidence that weak legal systems and weak governance systems in the target country will increase the discount factor and affect valuations. La Porta et al (2002) (*see endnote 11*) find that variations in valuations across countries are partly attributable to variations in legal and governance structures.

But does the regulator similarly conduct due diligence on the acquiring firm? The risk for a regulator is comprised of three risks

(1) The risk that a successful bidder may violate legal and other operating constraints and not be accountable for these violations because it is incorporated in another country.

(2) The risk that, because reporting requirements are different in another country, there will be limited disclosure on violations of legal and other operating constraints.

(3) The risk that the ownership structure of a successful bidder may change in the future, for example, that it be acquired by a bidder from another country with a weaker legal system and governance structure (for example, the US government opposition to the 2005 acquisition of the UK company Peninsular and Oriental Steam Navigation Co. by Dubai Ports World).

These risks are attributable to the separation of ownership and operations that Keynes highlighted in his treatise on self-sufficiency. They are well demonstrated in problems associated with environmental clean-ups. In 2000, a Romanian dam ruptured releasing cyanide into the Lapus and Tisa rivers in Romania and Hungary (*see endnote 12*). The cyanide was a component of an extraction process for recovering gold from tailings of previous gold mining activities. The operating company, Aural, was jointly owned by the Romanian government and the Australian company Esmeralda. Esmeralda declared itself bankrupt and its operations were taken over by a new company Transgold registered in Australia. The damage was extensive with over 700km of the Lapus and Tisa rivers affected, principally in Hungary. The Hungarian government sued Transgold in the Hungarian Supreme Court for \$105 million. However, individuals affected in Hungary had no recourse to Australian courts, and Australian authorities had no jurisdiction over the environmental crimes of an Australian company operating in a foreign country. As a result, organisations, such as Greenpeace called for an international instrument on corporate accountability and liability.

Differences in corporate accountability and liability across countries are being reduced by what Gilson (2001) (*see endnote 13*) terms corporate governance convergence. He identifies three types of convergence, functional, formal and contractual. Functional convergence occurs when firms improve their governance in response to new market conditions; for example the emergence of better governance in Chinese firms listed on the Shanghai Stock Exchange as the China equity market becomes more open to foreigners. Formal convergence occurs through changes in laws, for example, the set of protections for minority investors resulting from the Asian financial crisis of 1997. Contractual convergence occurs when firms change their corporate governance unilaterally, for example, through dual listing of securities in the US market. The convergence of corporate governance across

countries reduces the risk for a national regulator, because the risks of non-disclosure and of non-accountability are reduced. But corporate governance convergence does not necessarily reduce the risks of future violations of operating constraints.

How then should a regulator conduct due diligence to protect the national interest? The regulator's task is to assess the risks of a cross-border merger in terms of the probability that the bidder will act contrary to the national interest in the future; for example, that it will violate national security, that it will sell strategic resources to a non-compliant third party, that it will violate environmental and safety standards, or that it will significantly depreciate assets. When a regulator approves a cross-border merger, it confers legitimacy on the bidder, that is, there is an acceptably low risk that the bidder will default on its national interest obligations.

The probability that a bidder will default on its national interest obligations is best determined by the history of the actions of the bidder, or the legitimacy of the bidder. Legitimacy is a concept formalized by Suchman (1995) (*see endnote 14*) to denote the acceptability of a firm to external parties including shareholders, regulators and other stakeholders such as those who contract with the firm. For shareholders, the legitimacy of a firm is determined by the return on equity of the firm relative to its opportunity cost of capital. This pragmatic form of legitimacy is arbitrated by the stock market. However, in a cross-border merger, other types of legitimacy become relevant. In particular, the moral legitimacy of the bidder, defined by Suchman (1995, p.579) as the positive normative evaluation of the firm, becomes relevant. The firm's moral legitimacy is an indicator as to whether the firm will default on its national interest obligations. Unlike pragmatic legitimacy, markets do not usually price moral legitimacy. Only when there are substantial violations is moral legitimacy priced. For example, when the landowners downstream from the OkTedi gold and copper mine in Papua New Guinea filed an A\$4 billion lawsuit against the Australian mining company BHP in 1994, the moral illegitimacy of an environmental spill became a litigation cost, which adversely affected the balance sheet and the share price of BHP. The moral illegitimacy was priced. In a cross-border merger, it is the regulator who must price the moral legitimacy of the bidder. If the price is too low, the bidder may default on their national interest obligations.

The challenge for the regulator is then to price the bidder's moral legitimacy. Unfortunately, this is not an easy task. In pricing the moral legitimacy of a firm, there are a number of uncertainties. First, what constitutes moral illegitimacy? Are unfair employment practices, improper quality controls, violation of environmental standards and asset stripping examples of moral illegitimacy and, if so, how should they be weighted? Secondly, is the governance of the firm relevant in assessing the moral legitimacy of its operations; for example, is a history

of non-disclosure, or of non-compliance to accounting standards, evidence of moral illegitimacy. Thirdly, does previous moral illegitimacy predict future violations of the national interest; for example, if a bidder has a history of non-disclosure, does this increase the probability that it will sell strategic resources to a non-compliant third party. The regulator must not only determine what the national interest is, but whether a bidder's history correlates with that national interest.

What then is the cumulative evidence on cross-border mergers and the national interest? A survey of 420 senior executives by Accenture (*see endnote 15*) found that of those who had conducted a recent M&A, 58% identified this acquisition as a cross-border merger and 46% identified legal and regulatory compliance as the greatest challenge in conducting acquisitions. Given that the value of cross-border mergers into and out of OECD countries has doubled since 2003 (*see endnote 16*), the role of legal and regulatory constraints is clearly important. However, the extent of national interest protection provided by national regulators such as the FIRB in Australia is difficult to assess. The importance of the national interest can usually only be identified by

- (1) Rejections of a cross-border merger due to the national interest
- (2) Constraints imposed on a successful bidder in the national interest

And, for the most part, cross-border mergers are approved and usually with minimum constraints. There are very few examples of rejections, and most of these are the result of significant political lobbying, as exemplified by the 2005 acquisition of the UK company, Peninsular and Oriental Steam Navigation Co., by Dubai Ports World.

The maxim of the regulators charged with protecting the national interest appears to be that the national interest is best protected by imposing minimum impediments on the flow of capital and allowing companies to maximize the return on shareholders funds. National interest concerns relating to the separation of ownership and operations are rarely mentioned. They appear to have a low price. Because of the small number of rejections of cross-border mergers and of the limited information on the constraints imposed on bidders due to the national interest, we use a case study to examine the role of the national interest. We consider the unsuccessful bid of the Swiss company Xstrata for the Australian mining company WMC. This cross-border merger was chosen because it is representative of many of the issues discussed above. First, it required the approval of Australia's foreign takeover regulator, the FIRB, which has the power to reject mergers if they are contrary to the national interest. Secondly, the merger was strategically important because of WMC's control of a strategic national resource, uranium. Thirdly, many analysts questioned the moral legitimacy of Xstrata prior to the determination by the FIRB. The case study then provides insight as to how

the history of a bidder correlates with a national interest determination.

### 3. A Case Study of The Takeover of Western Mining Corporation (WMC)

#### 3.1. The Case History

In 2004, WMC was a diversified miner, which had begun in 1933 as a gold mining company (*see endnote 17*). Its Australian interests included nickel mining, nickel processing and fertiliser production, and it had a foreshadowed interest in a titanium oxide mine in Mozambique. However, its principal interest was the copper and uranium mine at Roxby Downs in South Australia, which accounted for nearly 38% of the world's known reserves of uranium. The Roxby Downs mine became pivotal to the takeover. It was widely believed that WMC was under-managing its resources, particularly Roxby Downs, a belief confirmed during the takeover when WMC increased its estimate of the Roxby Downs resource by nearly 30%. Roxby Downs was the asset which attracted the bidders. It was also an asset of national strategic interest. Speculation about a bid for WMC by the Swiss company Xstrata plc began in October 2004. Xstrata was also a diversified miner with 35% of its revenues from coal and 50% from copper (*see endnote 18*). It had already established a significant presence in Australia, with 2/3 of its coal production based in Australia. Xstrata began as a financial investment holding company, Suedelektra, in 1926 and had become an aggressive acquirer since transforming into a mining group in the 1990's. Critical to this transformation was the role of Glencore International, a corporation specialising in the trading of natural resources, which had acquired a controlling interest of Xstrata in 1990. The acquisition program of Xstrata began in 1997 with the purchase of a minority interest in an US aluminium smelter. Subsequent acquisitions included the South African vanadium producers Rhoex and Vantech, the ferrochrome producer CMI, the Spanish zinc and lead producer Asturiana de Zn S.A., Enex (the mining interests of Glencore) and the Australian miner MIM. In October 2004, Xstrata controlled more than 30 subsidiaries, principally in Australia and South Africa. But its headquarters were in Zug, Switzerland, and it was listed on the London and Zurich stock exchanges. There was a clear divergence between where it reported and where it operated.

Xstrata announced a cash offer of A\$6.35 a share for WMC on October 27 2004, a 29% premium on WMC's share price of the previous day. The offer was rejected by WMC's board, which regarded the offer as failing to recognize the value of WMC's assets (*see endnote 19*). In November 2004, Xstrata referred its offer directly to WMC's shareholders but, after two months, Xstrata had secured only 0.009 percent of WMC's shares. The offer was extended until February 28, 2005 (*see endnote 20*) and then increased to an unconditional offer of A\$7.00 per share. Xstrata

stated that it would not further increase its offer. The final Xstrata offer was at a 46% premium to WMC's pre-takeover share price, but it was not enough. The offer lapsed on March 24, 2005. Within a week, another diversified mining company, BHP-Billiton, issued a cash offer of A\$7.85 a share for WMC. The WMC board supported the BHP-B offer. The offer was subject to a condition that BHP-B must acquire at least 90% of WMC's shares. Initially, there was some reluctance from shareholders, particularly hedge funds, who anticipated further competing bids (*see endnote 21*). As a consequence, WMC traded above BHP-B's bid price, necessitating BHP-B to restate its position that they would not raise their bid, nor extend their offer. Subsequently, there was no bidding contest and BHP-B achieved its target of 90% control of WMC on June 17, 2005. Its successful bid cost A\$9.2 billion and it paid a premium of nearly 60% on the pre-takeover share price. This was within the range of independent valuations, which had valued WMC as high as A\$8.24 a share.

#### 3.2. The Regulators

The bids of both Xstrata and BHP-B required regulatory approval. The relevant regulators were the FIRB, the ACCC and the European Commission. Both bids were approved. Xstrata's bid was first approved by the ACCC in December 2004. The ACCC concluded that Xstrata would significantly increase its Australian market share in only one market -refined copper- and, even in this market, Xstrata would be constrained by import competition. It thereby deemed Xstrata's bid consistent with competition policy. However, the ACCC did not assess competition in the market for uranium, nor uranium as a strategic resource. The ACCC similarly approved the BHP-B bid, concluding that while the bid led to significant Australian market share in the markets for nickel, cobalt and silver, prices were internationally determined. The European Commission gave approval to the Xstrata-WMC merger in January 2005, declaring it compatible with the common market and with the European Economic Association Agreement. It similarly approved the BHP-B -WMC merger.

The principal regulator, however, was the FIRB. It approved the Xstrata bid in February 2005, subject to legal operating constraints relating to the mining, distribution and marketing of uranium. It approved the BHP-B bid two months later, subject to the same constraints pertaining to uranium. Since BHP-B had its headquarters in Melbourne and was listed on the Australian Stock Exchange, the two other constraints imposed on Xstrata were not imposed on BHP-B.

It was the FIRB which judged the national interest issues in the takeover of WMC. The Foreign Acquisitions and Takeovers Act (1975) established the FIRB to regulate foreign investment in the Australian mining sector, particularly uranium. The FIRB advises the Government, disseminates

information and monitors compliance with foreign investment policy. The FIRB evaluates foreign investment proposals, including cross-border mergers and real estate purchases, according to their consistency with government policy. A proposal will be rejected if deemed contrary to the national interest. The national interest was first referenced in policy in 1971, and first enshrined in legislation in the Foreign Takeovers Act of 1972 (*see endnote 22*). But it has never been defined. The FIRB monitors sensitive sectors including media, telecommunications, transport, and extraction of uranium. The bids of Xstrata and BHP-B for WMC were both monitored because of the Roxby Downs uranium mine.

There have been a number of criticisms of the FIRB. The first relates to its independence and to the secrecy of its decisions. The FIRB is a division of the Australian Treasury and, although it has its own Board, it is supported by Treasury staff and gives its advice in private to the Australian treasurer (*see endnote 23*). The Treasurer makes the final decision. An Australian Senate inquiry in 1994 (*see endnote 24*) expressed concerns about the secrecy and independence of the FIRB. It recommended the establishment of a new independent regulatory authority, and that the reasons for decisions made in the national interest be published. These recommendations were never enabled.

A second criticism of the FIRB relates to perceived impediments to foreign investment. On February 10, 2005, the Financial Times of London editorialised that the FIRB and its national interest criterion should be abolished, in response to national interest concerns expressed in Australia relating to the Xstrata bid for WMC. Golub (2003) (*see endnote 25*) found that Australia was one of the most restrictive countries for foreign direct investment in the OECD based on the national interest screening criteria. Both of these observations are the observations of external parties and ignore the overwhelming evidence that the FIRB is a benign regulator.

The FIRB seldom rejects foreign investment proposals. In 2004-05, the FIRB rejected 55 proposals out of 4415 decided, in 2003-04 64 proposals out of 4511 decided, in 2002-03, 79 proposals out of 4747 decided and in 2001-02 77 out of 4523 decided (*see endnote 26*). The aggregate rejection rate over four years was only 1.5% and all but two of these rejections were rejections of real estate purchases. The FIRB defends this low rejection rate by stating that it consults with foreign investors prior to bidding, and this consultation ensures conformity to the government guidelines. In 2004-05, for example, the notifying parties withdrew 287 proposals, in some cases because they were inconsistent with government policy. However, in the absence of information about withdrawn proposals and rejected proposals, it is impossible to determine whether a national interest criterion was violated.

The low rejection rates of foreign investment proposals suggest that the FIRB is a conciliatory

regulator. The limited information on specific cases and sectors tends to confirm this. In 2003-04, the FIRB approved a takeover of the food producer Berri Ltd, a takeover rejected by the competition regulator, the ACCC. In 2003-04, 56 acquisitions in the resources sector were approved for a total of A\$6.89 billion, and 38 acquisitions in the communications sector were approved totalling A\$18 billion. In 2003-03, approvals were given for a number of cross-border mergers in the food and beverage industry, and for a merger in liquefied natural gas in the Northern Territory. Xstrata, which had acquired substantial coal interests through its acquisition of Glencore Coal Australia Pty Ltd in 2001, augmented those interests with the acquisition of MIM Holdings in 2002. In 2001, the US company, Newmont Mining Corporation, acquired Australia's largest gold company Normandy Mining, one of a series of cross-border mergers in the gold sector amounting to A\$11.7 billion. In none of the cases was justification provided for the transfer of ownership of strategic resource interests in coal, gold, oil and gas, minerals and communications to foreign control. The separation of ownership and operations was never discussed. The only cross-border merger where national interest criteria appear to have been rigorously applied was in the rejection of the A\$9.7 billion bid of Shell Australia to acquire Woodside Petroleum Ltd in 2001. National interest concerns were cited as the reason for the rejection, but these concerns were never detailed. Shell argued that their takeover was in the national interest, as they would be developing the North West Shelf more quickly and more successfully and 'that can only be in the interest of Australia' (*see endnote 27*). Shell's Australian Chairman, Peter Duncan, could not see any reason for the Treasurer to decide against the takeover. But the Treasurer did decide against Shell, without detailing the reasons. The national interest is not only difficult to define in legislation. It is also difficult to specify in practice. When the 1994 Senate inquiry asked a member of FIRB management "what constituted the national interest", the response was that "we consult widely and take account of the various views that are there". When asked to identify the weight applied to specific national interest issues, the response was that "the Treasurer does that" and that "decisions are based on what has been done in the past" (*see endnote 28*). There is some inertia. How then does the FIRB's perception of the national interest correlate with community perceptions of the national interest? The FIRB maintains that community concerns are relevant in determining the national interest. But while FIRB was approving both the Xstrata and BHP-B bids for WMC, opinion polls (*see endnote 29*) indicated considerable opposition to the takeover. The first poll surveyed on February 16/17, 2005 showed 81 percent of respondents believed that Xstrata's bid should be rejected, 56 percent believed that BHP-B's bid should be rejected, and 60 percent believed that a possible rival bid by Rio Tinto should also be rejected by the

regulator. These responses changed little in a second poll in March. After the BHP-B bid was approved by the Treasurer, a third opinion poll was conducted and it showed that only half of the respondents agreed with the decision. The respondents raised concerns relating to BHP-B being a foreign company, and the separation of where the company is incorporated and where it operates. Clearly, the FIRB and the community had different perceptions of the national interest in the bids for WMC.

It would appear that Australia's national interest has a different meaning for foreigners than it has for domestic residents, and a different meaning for the FIRB than it has for domestic residents. These differences illustrate the difficulties in defining and protecting the national interest. Since it was the Xstrata bid, which evoked most of the discussion of the national interest, we now consider the national interest issues associated with the Xstrata bid.

### 3.3 The National Interest

There were five issues of national interest identified when Xstrata bid for WMC. They were the mining and distribution of uranium, foreign ownership of strategic resources, employment, the governance of Xstrata and environmental issues. Most of these issues were the subject of the public and political discussion which ensued at the time of the approval of the bid by the FIRB.

#### Uranium

Although WMC was a diversified miner, the Roxby Downs uranium mine became the main national interest issue. It was the mining of uranium in 1975 that initiated the Foreign Acquisitions and Takeovers Act, and it is uranium that is specifically listed as a sensitive sector by the FIRB. In the FIRB approvals of the bids of Xstrata and BHP-B, the main constraints were related to the mining, regulation and marketing of uranium. Uranium was central to the approval of the bids.

The proposed takeover brought into focus legislation related to the mining of uranium in Australia. The legislation has a variable history. Because of risks associated with radioactivity, the Australian government banned new uranium mines in 1984. With the closure of the Narbarlek mine in the Northern Territory in 1988, only two mines remained, one at Olympic Dam in South Australia and the other the Ranger mine in the Northern Territory controlled by Rio Tinto. The no new uranium mines policy was then annulled in 1996, and subsequently the US based General Atomics started operations in northeastern South Australia. Canada's Southern Cross Resources also plans to produce in the same area. However, public opposition put an end to plans to start uranium mining within the Kakadu National Park in the Northern Territory. The Mirrar, traditional owners of that part of Kakadu, which includes the Ranger and Jabiluka mineral leases, signed an agreement with

Energy Resources Australia that includes a veto on any future development of the Jabiluka mine site. The agreement also provides for significant rehabilitation at the mine site, which has not seen any construction work since September 1999 (*see endnote 30*).

The sensitivity of uranium mining is recognised in Australian state legislation. In Western Australia, uranium mining is banned, but in South Australia where Roxby Downs is located, the state government wants Olympic Dam to become the world's leading producer of uranium (*see endnote 31*). The sensitivity of uranium mining is also recognised in other statutes, for example in the 2005 US- Australia free trade agreement. In this agreement, the threshold required to obtain FIRB approval for acquisitions by US companies was raised from A\$50m to A\$800 million, but uranium projects were specifically excluded. Uranium is then a special commodity in Australia. Legislation on the mining of uranium is always evolving, and always a matter of high national interest. The legislation regulating the mining and distribution of uranium is designed to minimise a number of risks relating to the storage and handling of radioactive waste, the use of uranium in weapons and for terrorism, the handling of tailings at mining sites, and the excessive use of water in the processing of uranium. The Australian government's main concern is to prevent Australian uranium being used in a foreign weapons program. Consequently uranium is only sold to countries which have signed the Nuclear Non-Proliferation Treaty, and with which Australia has a bi-lateral agreement. Australia has agreements with 35 countries. The biggest customers are the US, Japan, South Korea, France and Britain. Sales to France were banned for a period because of its nuclear weapons testing in the South Pacific. And sales did not return to previous levels until France signed the Comprehensive Test Ban Treaty in October 1996. The Australian government regards the distribution of uranium, and particularly sales to third parties, as a matter of high national interest.

Regulation of the mining and distribution of uranium is complicated by fluctuations in the demand for uranium. The price of uranium is sensitive to two main risk factors, environmental risk and oil price risk. The 1978 nuclear accident at Three Mile Island, Pennsylvania and the 1986 nuclear accident at Chernobyl, Ukraine illustrated how environmental risks are priced. The price of uranium declined from approximately US\$40/pound in the late 1970s to only US\$7/pound in the early 1990s, a decline widely attributed to perceptions of environmental risk. By 2005, the price had recovered to US\$24/pound, principally due to increases in the price of oil. Future demand for uranium is highly uncertain. While China and India have started extensive nuclear programs, in Europe the construction of new reactors has slowed with Germany phasing nuclear reactors out. Because of these fluctuations in uranium demand, a government regulating the supply of uranium must balance short-term increases in revenues and royalties



against the long-term dividend from restricting supply and underpinning the long-term price. The national interest then extends to more than minimizing the security and environmental risks associated with uranium. It also relates to the optimal rate of extraction of uranium reserves.

In sum, uranium is a special commodity for Australia, enshrined in Federal and state legislation, in free trade agreements and in the strategic interest listed by the FIRB. The Xstrata bid for WMC intersected with this special national interest. It led to a complicated discussion of the trade-off between the free market and the national risk. The risk included not only security and environmental risks, but also the risk of losing control over the extraction of a strategic resource. We now consider this risk further.

### Foreign Ownership of Strategic Resources

When 81 percent of respondents in the opinion poll of February 2005 believed the Xstrata bid should be rejected, they were signalling a preference for less foreign control over strategic resources. Their preference, however, was not the preference of the government. The government leader in the Australian senate, Senator Hill, expressed the government's position in relation to the foreign ownership and control of Australia's hydrocarbon assets as

*"Australia, of course, with a relatively small economy in global terms, has needed to attract foreign capital for the development of those assets, the development of the assets brings wealth and benefits to our country, and that is why we and previous governments have been prepared to allow foreign investment in these assets. I accept that they are strategic assets as well as economic assets" (see endnote 32).*

Another government minister, Senator Minchin, in 2001 stated that foreign investment underwrites Australia's high standard of living, in particular, that companies with foreign ownership pay higher wages and are more export oriented than domestic companies (see endnote 33). The Australian government's approach is not unusual. Many governments provide incentives for foreign investment, presumably because they believe that benefits spill over from foreign to domestic firms. This proposition was tested in the United Kingdom in the manufacturing sector by Girma et al (2001) (see endnote 34). While they find greater productivity in foreign owned manufacturers with an associated wage differential, they find no evidence of a wage or productivity spill over to domestic firms. They attribute this finding to a significant technology gap between domestic and foreign firms.

The ownership of strategic resources has led to changes in foreign ownership rules in many countries. In Canada, recent discussions concerning the Chinese government securing Canadian resources have led Canadian business leaders to call for the tightening of foreign ownership rules. While these business leaders

were prepared to relax controls over media, banking and airlines, they were not prepared to cede ownership of Canadian resources to foreigners, preferring instead for foreigners to purchase from Canadian companies (see endnote 35). This asymmetry between the preference for control over strategic resources and other industries is critical to an understanding of the national interest. What the business leaders are expressing is the right to control the rate of extraction of a strategic resource, the right to manage its price and the right to manage the risks associated with its extraction, in other words, the right to manage a sovereign asset.

Most countries protect their sovereignty by limiting ownership of natural resources. In the Middle East, while the Gulf States are opening up their economies, in the UAE foreign investment is prohibited in real estate. In Saudi Arabia the oil sector is off limits to foreign companies, while Iran and Kuwait limit foreign ownership in the oil sector to 49 percent. In Yemen foreign equity in the petroleum industry is limited to 49 percent (see endnote 36). In Russia, the Natural Resources Ministry has just announced limits on foreign ownership of companies in the natural resources sectors (strategic oil and metals deposits) to 49 percent as the government reasserts state control over strategically important sectors (see endnote 37).

The FIRB decision to approve both the bid of Xstrata showed that the Australian government was prepared to confer 100 percent control of Australia's uranium supply to a foreign corporation. Such a decision is at variance with the foreign ownership limits used by Saudi Arabia and Russia, and the expressed views of Canadian business leaders. It suggests that the preferences for control over strategic interests stated in FIRB Annual Reports are nominal, and not binding. The strategic resource at Roxby Downs was apparently not a sovereign asset. The Australian government was prepared to subcontract the management of a strategic resource, and to transfer the risk to the subcontractor. Of course, the risk in this transference of control depends on the risks of the subcontractor, an issue we now consider.

### Employment

Cross-border mergers often lead to employment losses. A diversified miner such as Xstrata, involved in an aggressive acquisition program, will often acquire a reputation for unfairness in employee relations. In the discussion of the national issues related to the takeover of WMC, labour unions, particularly the Construction, Forestry, Mining and Energy Union (CFMEU) pointed to Xstrata's historical employment and health and safety practices. The CFMEU claimed that Xstrata had targeted union members for retrenchment at its Bulgar coal mine in the Hunter Valley, New South Wales (NSW). To support their case, 2000 miners went on strike for 24 hours (see endnote 38). On the March 11, 2005, the NSW Industrial Commission imposed a record

A\$1.47 million fine on Xstrata over the deaths of four coal miners at the Gretley mine in November 1996. Xstrata then challenged the validity of the health and safety laws that allowed for criminal convictions over this incident (*see endnote 39*).

But Xstrata was not the only company responding to questions of employment practices. The CFMEU accused BHP-B of deceptive practice in its intention to close the Elouera colliery in NSW, an intention that had a significant impact on the settlement of the miners' enterprise agreement, but an intention that was later revoked. Industrial accidents have also been a problem for BHP-B. The Ritter Inquiry into the deaths of three workers in separate incidents at BHP-B's Pilbara, Western Australia, iron ore operations confirmed problems with the health and safety systems at BHP-B operations (*see endnote 40*).

While employment practices are relevant to employees and to communities where operations are located, they are not necessarily of national interest. However, for Xstrata, one historical event became a national interest matter. In 1997, Xstrata acquired a controlling interest in a vanadium mine site at Windimurra, Western Australia. The Windimurra mine opened in 2000 with an expectation of a 30-year lifetime. The mine closed within 3 years, because of low vanadium prices. The state of Western Australia invested over \$30 million for infrastructure development in the project, and its early closure elicited a committee of inquiry, which concluded that (*see endnote 41*). "Western Australia's legislation has insufficient power to protect the public interest in mining development projects. The Committee has approached potential changes to the *Mining Act 1978* with the view that an open process must be maintained to provide fairness and certainty in Western Australia's mineral industry." Xstrata incurred significant reputation risk from the closure of Windimurra for three reasons. First, the Committee of inquiry found that the project could have been economically sustainable in the long term. The inference was that Xstrata had not committed to the project, and had shown undue sensitivity to the low vanadium price. Secondly, the closure of the mine had benefited the world vanadium price and, as a consequence, the South African operations of Xstrata. Xstrata had not given sufficient commitment to the Australian operations. Finally, Xstrata reduced the asset value of the mine by dismantling the infrastructure and then undermined the sale of the operation. Many state and Federal politicians regarded the actions of Xstrata at Windimurra as contrary to the national interest. The Premier of Western Australia urged the Treasurer, and by implication the FIRB, to reject Xstrata's bid, stating that

"Xstrata's record in Western Australia casts doubt on its ability to act as a good corporate citizen, which is one good reason why it should not be trusted with the large Western Australian mineral reserves held by WMC." For many, Windimurra was an example of moral illegitimacy.

## Governance

Windimurra induced observers to examine the governance of Xstrata and, inevitably, questions of governance became questions about Glencore. Glencore acquired a controlling interest in Xstrata in 1990. However, the links between Glencore and Xstrata were not well defined. Glencore, as a trading company, was the buyer and seller of Xstrata's products. It retained a 40 percent interest in Xstrata, but maintained its voting rights were only 16 percent. In February 2005, shortly after the FIRB approval of Xstrata's bid, the Australian Broadcasting Commission (ABC) (*see endnote 42*) profiled the links between Xstrata and Glencore. There were two central assertions. First, Glencore and Xstrata were not independent corporations. Three and possibly four of the twelve directors of Xstrata were also directors of Glencore. The culture of Xstrata was the culture of Glencore, influenced by common management and similar management principles. Secondly, Glencore had significant reputation risk related to its aggressive trading practices, the reputation of its founder Marc Rich, and its payments of kickbacks to corrupt regimes. The link between Glencore and Xstrata then represented a risk for Xstrata when it required FIRB approval. The FIRB needed to determine whether the link was relevant to the bid and to the national interest.

## Environmental Issues

Finally, both the Xstrata and BHP-B bids for WMC had significant environmental implications. Even under the ownership of WMC, the Roxby Downs mine faced environmental risks. Radioactive waste was stored in large retention ponds and any seepage into the ground water would affect the water supply. An Indenture Act<sup>1</sup> ratified in 1982 exempted the lessees (WMC) from State and Federal legislation. It allowed the withholding of environmental and health reports unless the lessees and the government agreed to their release. The Indenture Act also allowed the lessee to take up to 42 million litres of ground water a day without charge. With Australia seriously short of water, the usage and possible contamination of the water supply became a serious environmental issue. Both Xstrata and BHP-B foreshadowed a large expansion in the mine. Such an expansion implied a significant increase in the environmental risks.

### 3.4. The Approval

On February 11 2005, Xstrata's bid for WMC was approved subject to the four conditions that

1. Xstrata would abide by all Australian federal and state laws and regulations relating to the mining and regulation of uranium.
2. The headquarters and executive boards of Xstrata Coal, Xstrata Copper and the planned new business group, Xstrata Nickel, would be

retained in Australia whilst the majority of the assets of the respective businesses would be located in Australia.

3. XStrata's annual reporting disclosure would include the Group's annual exploration expenditure in Australia, and Xstrata would report on these activities annually to the Minister for Industry, Tourism and Resources.

4. XStrata would undertake prior consultations with the Department of Industry, Tourism and Resources on the terms of any and all marketing arrangements it enters into with third parties in respect of uranium, which will be subject to all regulatory requirements imposed as part of the Australian Government's regulations and disclosure rules relating to uranium sales out of Australia.

The conditions relating to uranium mining were the same as imposed on BHP-B when its bid was approved on April 4, 2005. However, the conditions on the location of the headquarters and disclosure of exploration expenditure were specific to Xstrata.

Did the FIRB protect the national interest when it approved Xstrata's bid? In assessing the FIRB decision, a number of points are relevant. First, the FIRB had no authority to limit Xstrata's interest in WMC to say 49 percent as in Russia or Yemen. The FIRB had to decide whether to approve or reject 100 percent control of WMC. Secondly, in approving control, the central issue became trust. Could Xstrata be trusted to abide by the conditions imposed on it, particularly related to the mining and distribution of uranium, and to satisfy environmental and health and safety standards? The moral legitimacy of Xstrata became important. Its actions at Windimurra and the link with Glencore were relevant, but deemed not sufficiently anomalous so as to reject the bid.

The FIRB decided that, in all probability, Xstrata would abide by the conditions imposed on them. Of course, after June 2005, the FIRB did not have to defend its decision. BHP-B acquired control and the Xstrata-WMC merger was only hypothetical. However, by approving the Xstrata bid, the FIRB conferred legitimacy on Xstrata, a legitimacy that will underwrite future bids. And it affirmed that the corporate history of a bidder does not necessarily matter. The national interest was nominally recognized. But the real price of the national interest was now uncertain.

#### 4. Conclusion

In this paper, we have considered the role of the national interest in determining the regulatory approval of a cross-border merger. Since both the number and value of cross-border mergers has markedly increased since 2003, this is an important question. A cross-border merger often poses a challenging question for regulators, because it entails a divergence between where the company reports and

where the company operates. This divergence is inimical to the national interest.

But what is the national interest? It is a term often used, but seldom defined. It has been variously described to consist of a hierarchy of interests beginning with national security, and including strategic resources and corporate governance. We have defined it as the ability of a national government to exercise regulatory control over its strategic interests, and over the companies operating within its borders. A cross-border merger, which dilutes this control, dilutes the national interest.

A regulator who assesses a cross-border merger must conduct due diligence on the acquiring firm. The risk for a regulator is that a successful bidder may violate the national interest, by violating legal and other operating constraints imposed on them. And, because they report in another country, there may be limited disclosure of these violations. To approve the merger, the regulator must determine that the bidder is morally legitimate, that is, it can be trusted.

We have applied these principles to the case of the takeover of WMC and, in particular, to the regulatory approval given to the bid by Xstrata. The case shows that even when strategic interests are involved, and the bidder has an anomalous corporate history, a cross-border merger may be approved. Some would suggest that the national interest had a low price. There are important policy implications from this analysis. First, the national interest should be defined, and not left to the discretion of public officials. This is important because it allows regulators to formalise the due diligence on bidders, and it leads to consistent decisions. Secondly, the role of cross-border mergers, in increasing the separation of ownership and operations, suggests the need to investigate a global instrument for corporate accountability and liability. Thirdly, formalisation of operating constraints such as those imposed on Xstrata and BHP-B should be considered; for example various licensing arrangements for control of strategic resources. These arrangements would mitigate the risks of regulatory failure. And protect the national interest.

#### Endnotes

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<sup>3</sup> A complete discussion of international agreements relating to national security is contained in United States General Accounting Office (1996) 'Foreign Investment: Foreign Laws and Policies Addressing National Security'

<sup>4</sup> See Christiansen, H. and A. Bertrand (2006) 'Trends and Developments in Foreign Direct Investment', OECD, June.

<sup>5</sup> The examples in this section are extracted from Christiansen, H. and A. Bertrand (2006) 'Trends and Developments in Foreign Direct Investment', OECD, June.

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- <sup>16</sup> A discussion of WMC Resources can be found on Wikipedia at <http://en.wikipedia.org>
- <sup>17</sup> A discussion on Xstrata plc can be found at <http://www.referenceforbusiness.com>
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