

COMMUNICATION FROM THE EUROPEAN COMMUNITIES

The following communication, dated 11 October 2006, is being circulated at the request of the Delegation of the European Communities.

**TRANSITIONAL REVIEW MECHANISM PURSUANT TO PARAGRAPH 18
OF THE PROTOCOL ON THE ACCESSION OF THE PEOPLE'S
REPUBLIC OF CHINA ("CHINA")**

1. The EC is transmitting the comments and questions set below in advance of the meeting of the Committee on Trade-Related Investment Measures (TRIMs) on 25 October, in order for the Chinese authorities to reply and to complete any information that may be incomplete. The questions build upon the previous meetings of the Committee on TRIMs on 14 October 2002, 3 October 2003, 25 October 2004 and 10 October 2005.
2. Once the information to be provided by China in accordance with paragraph 8 and paragraph IV.3(a) of Annex 1A of its accession protocol has been received, the EC may submit additional questions, including questions pertaining to issues that have been raised in previous EC communications.
3. At this point in time, the EC's comments and questions are focused on the following priority items:
 - Clauses contained in contractual arrangements that are incompatible with China's obligations under its Accession Protocol and the Regulations for the Implementation of the Law of the People's Republic of China on Sino-Foreign Equity Joint Venture.
 - New Automobile Policy.
 - Steel Industry Development Industry.
 - Petrochemical, chemical, energy and environment sectors.
4. In connection with its accession to the WTO, China has committed itself to comply fully with the TRIMs Agreement by abolishing legislation and other measures constituting illegal TRIMs upon joining the WTO and through "providing relevant information, including information contained in Annex 1A, to each subsidiary body in advance of the review". More specifically, Paragraph 7.3 of the Accession Protocol for China reads:

"China shall, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement. China shall eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export or performance requirements made effective through laws, regulations or

other measures. Moreover, China will not enforce provisions of contracts imposing such requirements. Without prejudice to the relevant provisions of this Protocol, China shall ensure that the distribution of import licences, quotas, tariff-rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in China."

TRIMs incompatible clauses in contractual arrangements

5. During the last TRM, China stated that "without the consensus reached through consultation between the consenting parties on any terms of an existing contract, the contract itself or some of its articles could not be altered or invalidated by a Chinese court or any other administrative body through a mandatory order."¹ In this context, the EC would be grateful if China could clarify how it is implementing its commitment to "not enforce provisions of contracts imposing the requirements" listed in paragraph 7.3 of the protocol of accession?

6. On earlier occasions China has also informed Members about the fact that the contracts and articles of association of a foreign invested enterprise become effective only after they have been approved by the competent authority. In this context how does China ensure that the "approval for investment by national and sub-national authorities" is not conditioned on performance requirements of any kind? In particular can China confirm that national and sub-national authorities are not bound by performance requirements stipulated in the industrial policies issued by the NDRC?

Regulations for the Implementation of the Law of the People's Republic of China on Sino-Foreign Equity Joint Venture

7. Article 41 of those regulations stipulates that: "The technology to be introduced to the joint venture shall be appropriate and advanced and enable the venture's products to display conspicuous social economic results domestically or to be competitive on the international market."

8. Could China explain how this requirement relates to the Accession Protocol requirements that "China shall eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export or performance requirements made effective through laws, regulations or other measures. (...) China shall ensure that any (...) means of approval for (...) investment by national and sub-national authorities, is not conditioned on (...) performance requirements of any kind"?

9. The EC further notes that Article 43 of the said Regulations requires that: "The technology transfer agreements concluded by a joint venture shall be submitted to the examination and approval authorities for approval." The remainder of Article 43 imposes several requirements on those technology transfer agreements.

10. Could China explain how these requirements compare to similar transactions between domestic parties and whether it considers that the said requirements result in equally favourable treatment for imported goods as compared to like domestic products?

¹ G/TRIMS/M/22, para. 22.

New Automobile Policy

11. The EC refers to its concerns regarding the New Automobile Policy (hereafter "NAP") already voiced in last year's transitional review, especially with a view to the wide scope of state intervention and the uncertainty about the implementing regulations that will supplement the new policy. Given the experience of how the NAP was developed, the EC wishes to stress the transparency obligations under WTO rules with regard to the outstanding implementation regulations of the NAP. Publishing drafts of these implementing regulations well in advance would allow other WTO Members to comment on them.

The EC would like to turn China's special attention to the following issues:

(i) Administrative measures for the import of automobile components fulfilling the characteristics of a whole vehicle

12. The EU believes that China is in breach of its obligations as a WTO member and its undertakings on joining the WTO. This issue has now been referred to the WTO Dispute Settlement Body and does not need to be reviewed in the context of the transitional review mechanism. The EU remains open to finding a mutually agreed, WTO-compliant solution.

(ii) Joint venture ownership limitation

13. The NAP imposes restrictions on foreign investors who have contributed substantially to the rapid development of China's automotive sector. Foreign joint venture partners are not allowed majority ownership in automobile production. Moreover, participation of foreign joint venture partners in automobile manufacturing projects is limited to two for the production of passenger cars and two for commercial vehicles ("2+2"). Due to the global nature of the automotive industry and the brand strategies of local companies locked in 50/50 per cent ventures with foreign vehicle makers such restrictions are counterproductive to the NAP's objective of promoting international competitiveness.

14. During last year's transitional review before this Committee, China stated that shareholding requirement was based upon the fact that China's automotive industry was at a preliminary stage of development and it did not contradict any WTO principle or China's accession commitments. The EC is fully aware of China's automotive industry evolution, which has significantly developed over the last years and has bright prospects – 8-9 per cent expected growth level over the next five years. Clear signs of overcapacity in the industry support the premise that the sector has reached maturity. Consequently, stringent regulations with the view of protecting a preliminary stage of development of the industry are no longer relevant.

15. With regard to the "2+2" requirements on setting up JVs, China noted that this requirement was designed to prevent investors from over-stretching their investment, opening multiple production sites and competing viciously with one another. From an economic point of view, this reasoning does not stand since investment decisions should be made according to business risk, and therefore, without arbitrary investment restrictions. A successful consolidation of the industry is not fostered, but, on the contrary, clearly hampered by the limitations on foreign shareholding in JVs and the "2+2" regulation.

16. China has confirmed the existence of an exemption to the "2+2" requirement for those "investors which, in association with their Chinese joint-equity partners, acquire or merge with other auto production companies in China".² The EC welcomes this exemption and China's argument that

² G/TRIMS/M/22, para. 27.

this is a step forward and a support attitude toward further consolidation of its automobile industry. However, the EC considers this exemption does not suffice since it does not apply to all foreign investors. Therefore, the EC encourages China to completely eliminate this requirement in all cases with a view to truly pursuing the consolidation of the automobile industry.

17. In this context the EC urges China

- to allow foreign majority investment; and
- to eliminate the "2+2" regulation.

(iii) Amendments to the Automotive Industry Development Policy

18. According to recent press releases, China envisages to modify the "Automotive Industry Development Policy" reinforcing the conditions for EU manufacturers to invest in China. According to these draft provisions, new investors would only be authorized to produce Chinese brand vehicles. Amendments to the "Automotive Industry Development Policy" may also concern the production of parts which could also be subject to Joint venture ownership limitation. This may have a very negative impact concerning the investment of EU car parts manufacturers in china. Finally, the Chinese government may also decide to grant financial support to Chinese manufacturers in order to promote export of vehicles.

19. In this regard, the EC would be grateful if China could:

- Provide information on the latest development on the "Automotive Industry Development Policy" regarding these three points in order to dispel legitimate concerns raised by the proposed policy.

Steel Industry Development Policy

20. In connection with last year's transitional review before this Committee, the EC raised questions regarding China's industrial policy for steel. In particular, the EC sought clarifications on Articles 23, 17 and 18 of the new "Steel Industry Development Policy". However, China did not respond to the related questions and invited Members to refer to China's statement made under the TRM at the Committee on Import Licensing Procedures of 16 September 2005. Yet, this statement did not relate to the abovementioned questions but only to new measures adopted by China on its import licensing regime. Therefore, the EC seeks again clarifications on the following issues:

21. Article 23 of the NDRC Steel Industry Development Policy states that "In principle, when investing in the Chinese steel industry, foreign investors will not hold a controlling stake". In particular, it is established that "A minimum owned capital of at least 40 per cent of the total capital needed". This limitation is counterproductive and will hinder the development and the investments. The EC requests that this artificial limit be lifted and that investments can take place on the basis of sound and objective factors.

22. In addition, Article 23 sets out that "enterprises must demonstrate they have the necessary funding, modern technology and management capacity, as well as demonstrate they have necessary, stable, and reliable healthy sales network, sufficient water and ore resources, coal, and electric power resources". As for foreign non-steel investors, the same Article states that "overseas non steel enterprises wishing to invest in the steel sector must demonstrate a high level of public trust". Article 23 appears thus to discriminate between domestic and foreign companies in that higher production volume thresholds are being set for foreign investors as compared to domestic common steel enterprises. In addition to that, additional tests are set for foreign non-steel investors, which do not appear to apply to domestic non-steel investors.

23. Paragraph 7.3 of China's Protocol of Accession stipulates that "*China shall ensure that (...) approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: (...) performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in China.*" By contrast, Article 23 of the new Steel Policy appears to make foreign investment conditional upon ownership of independent technology/intellectual property rights.

24. In that context, the EC would be grateful if China could explain in detail:

- By what criteria and on what basis does China intend to establish whether a company *has the necessary funding, modern technology and management capacity, a stable, and reliable healthy sales network, sufficient water and ore resources, coal, and electric power resources?*
- By what criteria and on what basis does China intend to establish whether a non steel company has *a high level of public trust?*
- Would China please clarify whether the requirements of Article 23 will also apply to Chinese companies which do not engage in inter-regional investment nor in establishing combined steel enterprises?
- Would China please explain why different standards are being set for domestic and foreign companies, like those regarding:
 - (a) minimum production thresholds, or
 - (b) additional tests for non-steel companies.
- Would China please explain how her decision to make foreign investment in the steel sector conditional upon ownership of independent technology can be justified under her accession protocol and the report of the working party?

25. The EC notes that Article 17 envisages a ban on outdated techniques and equipments. For this purpose, a list of outdated production capacity, techniques and products has been or will be established. In addition, Article 18 of the NDRC Steel Industry Development Policy reads: "*Policies for imported technologies and equipments: use of national equipment and technologies is encouraged, and import is to be reduced. The equipments and technologies that must be imported because they can not be made in China or can not meet the requirements must be advanced and practical. The manufacturing of the equipments which are largely needed in the future will be localized. Use of outdated and second hand steel production equipments eliminated either at home or overseas is prohibited.*"

26. In this regard, the EC would be grateful if China could explain in detail:

- on what basis the list of outdated production capacity, techniques and products (Article 17 of the Steel Industry Development Policy) has been or will be established;
- the definition of "outdated equipments";
- the measures it intends to take to encourage use of national equipment and technologies and to localize the manufacturing of the equipments which are largely needed in the future;

- whether China intends to impose a condition on the importation of equipments and technologies, namely that they cannot be made in China or cannot meet the requirements;
- the definition of "advanced and practical equipments" in this context and whether China intends to impose such a condition on the importation of such products;
- the implementing measures as well as their timing.

Petrochemical, chemical, energy and environment sectors

(i) JV ownership limitations and local content requirements

27. The Chinese Authorities maintain a foreign investment ceiling in some cases of a less than 50 per cent ownership position for the foreign partner that impedes further growth and investments in those sectors. In addition, local content requirements are in place for the construction of new plants. In particular, these local content requirements could reach a 70 per cent for new projects in the renewable energy sectors, requirements that might be extended to other sectors- i.e. the chemical industry. In light of these measures and the fact that they are in clear inconsistency with the TRIMs Agreement and China's commitment in paragraph 7.3 of China's Protocol Accession, the EC seeks some clarifications in the abovementioned measures.

28. In that regard, the EU would be grateful if China could clarify the following issues:

- On which basis does China impose shareholding restrictions?
 - Could China explain in a systematic way what local content requirements currently exist in the renewable energy and in the chemical sector?
 - Does China plan to extend these local content requirements and, if so, in which sectors?
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