

COMMUNICATION FROM THE EUROPEAN COMMUNITIES

The following communication, dated 15 October 2007, 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 CHINA¹ ("CHINA")**

1. The EC is transmitting these comments and questions in advance of the meeting of the Committee on Trade-Related Investment Measures (TRIMs) on 1 November 2007, 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, 10 October 2005 and 25 of October 2006, as well as previous questions from the European Communities as contained in documents G/TRIMS/W/21, G/TRIMS/W/31, G/TRIMS/W/36, G/TRIMS/W/41 and G/TRIMS/W/50.
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. 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". In particular, 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

¹ WT/L/432

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."

4. At this point in time, the EC's comments and questions are focused on the following priority items:

I. AUTOMOBILE INDUSTRIAL POLICY

A. JOINT VENTURE OWNERSHIP LIMITATION

5. In connection with prior transitional reviews before this Committee, the EC signalled 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, a foreign investor is limited to setting up no more than two such Sino-foreign joint ventures 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 Chinese authorities' objective of promoting international competitiveness.

6. During last year's transitional review before this Committee, the EC argued that such stringent regulations with a view to protecting a preliminary stage of development of the industry were no longer relevant, given the outstanding performance of the already mature Chinese automobile industry. China responded that it was "legitimate for the Chinese government to provide guidance on development of the industry based on its independent judgment of the maturity of the industry". In addition, China claimed that this was "not in any way related to WTO or our accession commitment".

7. The EC fails to understand the economic and legal groundings for applying such investment restrictions in the Chinese automobile industry. We note that the Chinese government is determined to guide and shape the development of the automobile industry. However, maintaining investment restrictions such as the limitations on foreign shareholding in JVs and the "2+2" regulation do clearly hamper the consolidation of this industry, and serve instead as deterrents for competitive, non-discriminatory investment decisions. To ensure a level playing field, investors (foreign or national) should be allowed to hold a percentage of shares in an automobile-producing venture proportional to the business risk they are prepared to take, and irrespective of external restrictions.

8. 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 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 really pursuing the consolidation of the automobile industry.

9. In this context the EC urges China

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

² G/TRIMS/M/22, paragraph 27 and G/TRIMS/W/51.

II. STEEL INDUSTRY DEVELOPMENT POLICY

10. 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 "Steel Industry Development Policy".

11. Article 23 of the NDRC Steel Industry Development Policy states that "[i]n 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". The EC argued that this limitation was counterproductive and would hinder a sound development of the steel industry and investment flows in the sector. China replied that this restriction in foreign ownership was not related to the mandate of this Committee. The EC, however, understands that China could provide further information on the economic and legal basis for applying such restrictions, which clearly impose artificial limits to investment decisions in the steel sector. In addition, the EC urges China to lift this foreign ownership limits so that investment decisions could be based on sound, objective foundations.

12. 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". During last year's transitional review, China asserted that these requirements applied for both domestic and foreign companies.

13. In this regard, the EC would be grateful if China could respond to the following questions in detail:

- (a) Could China confirm that the criteria used to define requirements pursuant to Article 23 are identical for both foreign and domestic companies? If criteria were different, could China elaborate on the reasoning for applying different requirements?
- (b) Could China confirm if any additional tests are set for foreign non-steel investors, which do not apply to domestic non-steel investors?
- (c) On what basis does China establish that a company, foreign or domestic, 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? What are the criteria used so as to define these requirements?
- (d) On what basis does China intend to establish whether a non steel company, domestic or foreign, has *a high level of public trust*?

14. 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 cannot be made in China or cannot 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".

15. In light of China's commitments in paragraph 7.3 of China's Protocol Accession, the EC would be grateful if China replied to the following questions in detail:

- (a) Further to China's reply regarding the definition of "outdated equipment"³, could China indicate where we can consult the catalogues of outdated production capacity techniques and products? Has this criteria been clearly defined, i.e. pollution levels, energy consumption levels, etc.?
- (b) What measures does China intend taking to encourage the use of national equipment and technologies and to localize the manufacturing of the equipments which are largely needed in the future?
- (c) Could China confirm whether it 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?
- (d) Could China clearly define the term "advanced and practical equipments" in this context and indicate whether it intends to impose this condition on the importation of such products?

III. PETROCHEMICAL, CHEMICAL, ENERGY SECTORS

A. JV OWNERSHIP LIMITATIONS

16. In relation to last year's transitional review, the EC addressed the foreign ownership ceiling, in some cases of a less than 50 per cent, which impedes further growth and investments in sectors such as the petrochemical, chemical, energy and environmental sectors. In particular, the Measures for Operation and Management of Clean Development Mechanism (CDM) projects, as published in October 2005, set out the general rules and specific requirements for the application for, and approval of, CDM projects, including a restriction on the threshold for foreign ownership of CDM projects in China to 49 per cent. Under this regulation, a company in China that is wholly or majority-owned by foreign investors will not qualify as CDM projects in China. We should note that the lack of project ownership is an additional risk that investors must consider when investing in a CDM project. This regulation discourages investment and results in fewer projects being undertaken that would have otherwise been beneficial to China's efforts to improve energy efficiency and reduce environmental emissions.

17. We note that China's rapid industrial development and ensuing environmental challenges has created a strong need for the types of energy saving technologies used in the context of CDM projects. In this regard, a further opening of the CDM market would create more incentives that would allow China to meet its environmental and energy saving goals in a much shorter period. In light of this, China may wish to consider allowing foreign companies to have majority ownership in CDM projects. The EC would like China to comment on the basis upon which it imposes these restrictions and its future plans to eliminate them.

B. LOCAL CONTENT REQUIREMENTS

18. The EC notes that the Measures for Operation and Management of Clean Development Mechanism (CDM) projects do also include local content requirements. For instance, and with regard to the energy sector, the current policies do not encourage the participation of foreign invested JVs and enterprises as suppliers of equipment in the power generation and transmission sectors. Government agencies and related SOEs are required to purchase new and advanced technology equipment and services only from domestic companies. In particular, these local content requirements

³ G/TRIMS/W/25, paragraph 37.

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. During last year's transitional review, China noted that "it was not aware of any local content requirements in these sectors". However, the ruling operational measures for the management of CDM projects are illustrative of the use of local content requirements.

19. In light of China's commitments in paragraph 7.3 of China's Protocol Accession, the EC seeks some clarifications regarding these measures.

- (a) Could China confirm that government agencies and related SOEs are required to purchase new and advanced technology equipment and services only from domestic companies?
- (b) Could China elaborate on the local content requirements currently applied in the renewable energy sector and in the chemical sector?
- (c) In addition, could China confirm that foreign invested joint ventures and enterprises that are established and duly registered in China are equally treated as domestic enterprises as suppliers of equipment and services in the power generation and transmission sectors?

20. In addition, the EC would like to seek clarification regarding the existence of draft legislation from the National Development and Reform Commission (NDRC) aiming at increasing the localization of large-scale petrochemical projects. Several sources indicate that provisions in the draft legislation would require project developers to submit an equipment procurement list to the Chinese authorities and forbid the import of equipment that has already been produced and marketed locally. Tax policies would be implemented to limit the import of equipment that can be produced domestically but is not yet commercialized. The overall objective would be to achieve a 75 per cent localization rate by 2010.

21. In this context, the EC would like to pose the following questions:

- (a) Could China confirm whether such draft legislation is indeed under preparation?
- (b) If so, could China inform Members whether it has consulted relevant stakeholders during the preparations of the draft legislation? In addition, could China indicate where we can find a sample of this draft legislation?
- (c) Could China confirm whether the abovementioned localization requirements are in full compliance with paragraph 7.3 of China's Accession?

IV. TRIMS INCOMPATIBLE CLAUSES IN CONTRACTUAL ARRANGEMENTS

22. During the last year's transition review, the EC addressed concerns regarding the procedures to amend contracts that contained TRIMs incompatible clauses. China noted that "the investors may decide by themselves whether to change the terms" of a contract, and if so was decided, "they may file the application to relevant authorities to change their articles of association or contract of enterprise accordingly". In addition, China stressed that this application would be "processed timely and in a manner consistent with TRIMs agreement"

23. In relation to this statement, the EC would like to pose the following questions:

- (a) Could China indicate the number of applications that have been filed in this context?

- (b) As regards the application process, could China brief on the steps to follow and the role of national and sub-national authorities throughout the process?
- (c) How does China ensure that the "approval for investment by national and sub-national authorities" is not conditioned on performance requirements of any kind?
- (d) How does China ensure that the "approval for investment by national and sub-national authorities" is not conditioned on local content requirements of any kind?
- (e) 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?
- (f) Overall, how does China monitor the application process so as to ensure its compliance with the TRIMs Agreement?

V. REGULATIONS FOR THE IMPLEMENTATION OF THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON SINO-FOREIGN EQUITY JOINT VENTURE

24. In connection to prior transitional reviews, the EC addressed certain particularities of the regulations for the implementation of the Law of the PRC on Sino-foreign equity JVs, and in particular, regarding provisions pursuant to Article 41, which stipulate that "[t]he 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". In response to EC's concerns regarding compatibility of these requirements with China's Accession Protocol, China stressed that Article 41 aims at ensuring that technology is "appropriate and advanced", though it is not a performance requirement as such.

25. However, we would like to highlight that Article 43 requires that "[t]he technology transfer agreements concluded by a joint venture shall be submitted to the examination and approval authorities for approval". In addition, the remainder of Article 43 imposes several requirements on those technology transfer agreements.

- (a) Provided that the provisions of Article 41 are not performance requirements, as asserted by China, how does China explain the provisions for the authorities' approval set forth in Article 43?
- (b) Could China indicate whether the provisions of Articles 41 and 43 are related to both domestic and foreign enterprises?

VI. NEW ANTI-MONOPOLY LAW

26. The EC welcomes the adoption of the Anti-Monopoly Law and looks forward to the publication of its implementing rules. The EC hopes that this law and its various components (i.e. the national security clause) will be applied in a fair, transparent and non-discriminatory manner in order to benefit the Chinese economy and Chinese consumers. In addition, the EC would like to remind Chinese authorities about the importance of consulting all stakeholders during the preparations of draft implementing measures.

27. In this context, the EC would like to pose the following questions:

- (a) Could China elaborate on the time frame for adopting these implementing rules?
 - (b) What is the role of the newly created "Anti-Monopoly Commission"? What is the expected date for this new Commission to become operational?
-