KPS China Looks to Australia for First Offshore Manufacturing Facility

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This case was developed with the cooperation of KPS China, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

This case study describes the investment experience of KPS China. It outlines the company's reasons for coming to Australia and the processes involved in setting up a business in there. It details some of the challenges faced by the company and how they were resolved. The case study also describes the roles played by National and State government agencies in facilitating the investment.

Founded in 2001, KPS China was based in the high-tech zone of Wuxi in Jiangsu Province, China. The company developed a patented technology which transformed leftover wool into a fire-resistant material that could be used for insulation and sound absorption, providing an alternative to solutions made from mineral or chemical-based substances such as asbestos. This made the material safer to produce and minimized environmental damage during the manufacturing process.

In recent years, the increasing demand for "green" products that were sourced, produced and distributed with minimal impact on the environment benefited KPS China's business. The company's wool-based products had found a market among construction companies and automotive manufacturers who wanted to ensure that their materials would be safe for the environment and for the workers who manufactured them.

As a result, KPS China experienced rapid expansion, achieving annual growth of up to 30% each year after its establishment. The 35-person company exported to Japan and expected its annual revenue to exceed RMB 80 million (US$ 10 million) in 2007.

Its business growth prompted KPS China to look overseas for raw materials and new markets. The company was searching for an investment destination that offered the vast amounts of wool it needed to support existing and future manufacturing requirements. It also considered the presence of a market for its products in the host economy, as well as ease of expansion to other locations in the region. There was a need to reduce transportation costs, so it made sense to be close to both suppliers and customers. In addition, the company wanted to do business in a location that offered economic and political stability and provided a welcoming environment for foreign investors.

Besides Australia, KPS China considered investing in the United States. However, it selected Australia as its first overseas investment destination because of the quality and quantity of raw materials, access to a skilled and multilingual workforce, established manufacturing infrastructure, and a business culture that facilitated trade with key markets in Europe and the United States.

The chairman of KPS China, Mr Shen Ping, was also familiar with Australia, having visited there for the first time during the Sydney Olympic Games in 2000.

"I visited Australia seven or eight times since 2000, and felt like I knew the place quite well. During these visits, I met several Australian wool suppliers and researched the building materials market. I was reassured that there would be a reliable supply of wool and customers to sustain our investment. I felt very comfortable doing business in Australia."

This case was written by Ms Julia Zhu, Senior Investment Director, Industry, Tourism and Resources, Invest Australia, and reviewed by Dr Paul Kennelly, Foreign Investment and Trade Policy Division, Australian Treasury. Invest Australia was absorbed by Austrade (Australia) in July 2008.

Australia-China Trade Relationship

Australia was an attractive business destination for foreign investors. According to AT Kearney, Australia was the eighth most popular destination for foreign direct investment (FDI) worldwide and the third most attractive FDI location in the Asia-Pacific region, after China and India.[1] Total FDI stock in Australia amounted to AU$ 331.4 billion in 2006-2007, a 14.3% increase on the previous year.[2]

Australia's major sources of FDI were Japan; the United Kingdom; and the United States. However, it was also experiencing strong growth in FDI from developing economies such as China and India. While Australia was known for its resources and agribusiness industries, its sophisticated services sector, which accounted for 77% of the economy, was also attracting attention. The Australian biotechnology and nanotechnology industries were also drawing significant interest.

Australia and China had a long-standing investment relationship. In 2006, China and Hong Kong, China, combined, made up Australia's fourth largest source of foreign investment.[3] The total value of the stock of foreign investment from China and Hong Kong, China in 2006 was AU$ 41.9 billion. China's Ministry of Commerce estimated that Australia was the seventh most popular destination for Chinese outward FDI.[4] Yanzhou Coal Mining, Huawei Technologies and Zensun (Shanghai) Science & Technology Co., Ltd were some of the companies that had investments in Australia.

In April 2005, negotiations began for a Free Trade Agreement between Australia and China. If successful, it could produce substantial increases in trade and investment between the two economies. Independent economic modeling suggested that an FTA covering all sectors would increase output and employment for both Australia and China. Under full liberalization, Australia's real GDP would receive a US$ 18 billion (AU$ 24.4 billion) boost in present value terms over the period 2006-2015, and China's real GDP would increase by up to US$ 64 billion (AU$ 86.9 billion) over the same period.[5]

Local Partnerships

By setting up a manufacturing facility in Australia, KPS China could liaise directly with suppliers and draw on the resources and services of Australia's well-established wool producers and industry organizations.

Australia accounted for one-quarter of global wool production in 2005-2006, making it the world's largest wool producing economy. Around 461 million kilograms of greasy wool were produced in 2005-2006 from 107 million sheep. Wool exports were valued at AU$ 2.64 billion in the same period, with China, Chinese Taipei, and the European Union as the main export destinations.[6]

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[1] AT Kearney, *2005 Foreign Direct Investment Confidence Index.*

[2] Invest Australia, http://www.investaustralia.gov.au/News/2007/Inflow19art1.htm

[3] Combined flows are measured because a substantial amount of Chinese outward FDI is channeled through Hong Kong, China. Data source: ABS, July 2007.

[4] MOFCOM, September 2006.

[5] Department of Foreign Affairs and Trade, http://www.dfat.gov.au/geo/china/fta/modelling_benefits.pdf

[6] Australian Bureau of Agricultural and Resource Economics, 2007.

Mr Shen noted, “Our products make use of wool remnants that would otherwise be discarded by mills. A major reason for setting up operations in Australia was the presence of plenty of wool waste. Victoria is a major wool-producing state so locating our operations here is very cost-effective for our business.”

Victoria accounted for approximately 93 million kilograms of greasy wool produced in 2005–2006.[7] Several Australian wool companies, such as Southern Wool Exports and Victoria Wool Processors, were headquartered in the state, making it easy for KPS China to meet their potential business partners.

“The opportunity to partner with local suppliers was very attractive,” said Mr Shen. “We have signed contracts with three local suppliers, including Dynon Wools Australia and Aulison Australia Group, and expect to source up to 2,000 tons of wool waste in the first year of production.”

KPS China had invested US$ 3.5 million in a factory in Laverton, about 18 kilometers southwest of Melbourne, the capital of Victoria. Once it goes into full production, the company could expect to manufacture 2.4 million square meters of insulation materials a year.

Should its business experience rapid growth, sourcing more raw materials would be relatively easy for KPS China. The company could link up directly with wool producers in other states, particularly New South Wales, which produces 33% of Australia’s total wool production. Also, KPS China had the option of having its Victorian suppliers source additional wool waste from producers in other states.

A Bridge to Western Markets

KPS China planned to invest an additional US$ 14.5 million over the following three years to ensure that it would achieve a sales target of US$ 25 million, of which US$ 15 million would come from exports.

According to Mr Shen, establishing a production plant in Australia would help KPS China meet these goals. He believed that Australia’s Western business culture and established links with Europe and the United States would make it easier for the company to enter these markets.

“One of our biggest contracts with a US client was signed through our Australian company. Due to differences in language, culture, business model and legal systems, some clients from North America are more comfortable dealing with a Western company or one that operates in a Western economy, even though we offer similar products, prices and services. As Australia has strong business links with the European and North American markets, our Australian factory not only serves as an offshore production center, but also as a shopfront for KPS China, opening us to a wider world market.”

The Australian office was securing half of KPS China’s orders from Europe, and almost all its orders from the United States. Mr Chen explained that “once our products pass the final examination by the regulatory authorities of these markets, we expect our annual turnover from these two regions to total US$ 30-50 million within three to five years.”

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[7] Australian Wool Innovation, 2007.

Sourcing Local Workers

KPS China aimed to employ around 95 local technical management staff and frontline workers within three years of establishment. The company planned to hire native English speakers for sales and marketing to make it easier to build relationships with customers. Also, it wanted to employ Chinese-speaking staff to facilitate communication with colleagues in China. The company engaged a recruitment agency to assist in sourcing these two types of employees.

With nearly one quarter of its population born overseas, Australia is the most multicultural economy in the Asia-Pacific region. Almost three million Australians or 15% of the population speak a language other than English at home. Sourcing Australian workers who can communicate with colleagues in China should be relatively easy for KPS China as around 400,000 Australians speak Mandarin, Cantonese or another Chinese dialect.[8]

The Australian workforce is also highly educated. Australia is one of the economies in the world with the highest general literacy.[9] On average, one-third of the workforce across all industry sectors has tertiary qualifications.[10]

In addition, Australia has one of the most productive workforces in the world. Australia's average annual increase in productivity of 2.1% between 1991 and 2004 outpaced the OECD average of 1.8% for the same period.[11] An Australian Government report found that between 1986-1987 and 2005-2006, labor productivity in Australia increased by 36% while unit labor costs decreased by 10%.[12]

Infrastructure Needs

Extensive, reliable infrastructure was a key requirement for KPS China. The company which intended to ship its goods back to China—as well as to customers in Europe and the United States—was attracted to Australia's elaborate global air and sea network. Australia's comprehensive freight and logistics services and efficient road and rail networks ensured that goods could be transported easily and affordably.

Mr Shen found the Australian logistics system efficient and the transportation infrastructure extensive and reliable. Furthermore, Mr Shen further said, "Although the manufacturing industry is small compared to China, it is more mature and hence more experienced in all aspects of the production process. Having said that, I believe there is potential for us to replace some low-grade products here."

[8] *Ibid*.

[9] *IMD World Competitiveness Yearbook 2006.*

[10] Australian Bureau of Statistics, 2006.

[11] *OECD Economic Outlook 79*, 2006.

[12] Australia's Treasury, 2006.

A Coordinated Approach to Investment Attraction

KPS China's entry into Australia was made easier with the assistance of Invest Australia, the Australian Government's inward investment agency.[13] The agency was represented in major American, Asian and European markets, with offices in 18 locations including Beijing, Guangzhou and Shanghai. Between July 2002 and June 2007, Invest Australia played a verified role in attracting or facilitating 387 projects worth approximately AU$ 55.8 billion, with the potential to create more than 27,900 jobs and generate AU$ 12.6 billion in export earnings.

In the past, the efforts of the Australian Government in pursuing FDI had been hampered by the lack of a national strategy and an uncoordinated approach to investment promotion and attraction. In its 2002-2005 strategy, *Global Returns*, and its subsequent 2006-2008 strategy, *Advancing Australia*, Invest Australia made a clear commitment to develop constructive partnerships between National agencies, State and Territory governments and industry representatives.

Invest Australia was driving a coordinated approach to investment promotion and attraction by establishing and providing ongoing support to a number of forums which brought stakeholders together, including the National Investment Advisory Board (NIAB).

The NIAB was chaired by the Chief Executive Officer of Invest Australia and comprised the heads of State and Territory investment agencies or their representatives. The NIAB members had contributed significantly to a number of key activities such as setting priorities for cooperation in investment attraction (including investment-related research and marketing), inter-government protocols on investment leads, conduct of site visits, investor facilitation services and aftercare programs.

The close working relationship among the different levels of government was evident when dealing with KPS China. Invest Australia worked closely with Invest Victoria—the government agency charged with attracting investment to the state of Victoria—to facilitate KPS China's entry into Australia. The two agencies jointly provided KPS China with information about investing in Australia and set up meetings with National and State government officials and industry representatives. Mr Chen related that Invest Australia did not "recommend" any specific state or city, but left the choice to KPS China after giving them the necessary information.

KPS China first came to Australia in 2000 to have business discussions with building materials suppliers. The company visited Melbourne in 2004 to gather more information and determine the viability of setting up operations in the state. In 2005, it registered KPS Wool Insulation (Aust) Pty Ltd in Melbourne, Australia. The following year, the company made two visits to Melbourne. On these visits, Invest Victoria organized the company's meetings with industry representatives, wool producers, legal and finance firms, local councilors and real estate companies.

"The aim was to put KPS China in touch with people who could help the company set up its business," said Mr Zhining Yang, the manager of International Investment, Invest Victoria. "The meetings gave KPS China a better understanding of the business and legal environment and the logistics and costs involved in coming to Australia."

[13] From 1 July 2008, the functions of Invest Australia have been subsumed by Austrade. See http://www.austrade.gov.au/

KPS China met with:

- the Victorian Department of Innovation, Industry and Regional Development to receive a briefing on the state's wool industry and investment opportunities;
- wool producers to discuss partnership possibilities;
- local council representatives in the area where it was considering a factory site;
- a transportation company to scope logistics and customs issues;
- a major Australian bank and legal, accounting and business consultants to sort out the technicalities of establishing a company; and
- a home products retailer to determine if there was a market for its insulation products.

"When we visited Australia, the local government was very friendly and happy to help out," said Mr Shen. "The officials welcomed and provided us with good accommodation and showed us around the local community. They even worked over the weekends to fit in with our tight schedule."

Overcoming Visa Issues

KPS China was keen on bringing in key personnel from China to manage its Australian operations. At that time, Invest Australia was offering a Supported Skills Program which enabled foreign companies making a significant investment in Australia to bring key expatriate managerial and specialist employees from within the company who were essential in setting up operations.

Invest Australia worked closely with the Department of Immigration to explain the significance of KPS China's investment in Australia and the necessity for senior KPS China officials to be granted long stay visas in order for the investment to proceed. While there were some delays, KPS China was eventually granted visas for nine key personnel as a result of Invest Australia's representations.

According to Mr Shen, the Supported Skills Program was vital for the successful setup of KPS China's Australian plant. "Our critical people included the General Manager, who would serve as the CEO of the Australian operation, General Sales Director, Financial Director, R&D Specialist and Production Manager. These people would build up a core team to run the plant with assistance from local Australian staff, and ensure that the operation would be up to the standards demanded by head office."

Under the Supported Skills Program, applicants completed an investment application form and addressed the eligibility criteria. Applications were then forwarded to the Department of Immigration and Citizenship for comment and advice. If the application was acceptable, an Immigration Agreement was forwarded to the company for sign-off. The company could then begin applying for visas for the personnel it wanted to bring to Australia.

KPS China had supplied the necessary documentation to the Department of Immigration, and the actual visas for the nine personnel were already being processed.

As of 2008, the Supported Skills Program was no longer offered, but there were other visa categories that might be suitable for international companies.[14]

[14] See Department of Immigration at http://www.immi.gov.au/

Resolving Energy Problems

After signing the lease on the factory, KPS China realized that energy output available at the site was insufficient to support its planned large-scale production. The company required 500 kV of power for its machinery but the factory site only offered 250 kV.

To remedy this situation, Invest Victoria linked KPS China with Powercor, a local electricity distributor, who replaced the energy transformer at the site with a larger capacity machine. This prompt action enabled KPS China to proceed with the shipment of its manufacturing equipment to Australia so that it could begin production as soon as its key staff members from China arrived.

Expansion Plans

Once the manufacturing operation runs smoothly, KPS China plans to establish a research and development (R&D) center in Australia. The center, scheduled to be opened in mid-2008, would be located within the factory to ensure easy access to materials and facilities. As explained by Mr Shen, “We need to conduct a lot of field experiments and testing, which cannot be completed in a separate laboratory. The objective of the R&D center is to develop our core technology and work on new products that meet the requirements of local, North American and European markets. We believe research is essential for the further growth of our business.”

KPS China also hoped to purchase land in Australia within the next three years to replace its rented premises with a larger production facility and more advanced equipment. Mr Shen said, “Australia holds great promise for us and we are looking forward to seeing our investment come to fruition.”

Real Estate Development Project in Chile by a Private Entrepreneur of Malaysia

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Executive Summary

This case focuses on an urban development project that a private corporation organized in Malaysia attempted to carry out in Central Chile between 1996 and 1997. The project intended to build a satellite town on 600 hectares of rural property with an initial investment estimated at US$ 17.136 million. The prospective investor submitted to the Foreign Investment Committee of Chile (CIE) the required investment application, which was approved by the agency on 3 March 1997.

Notwithstanding the CIE approval, the foreign investor still faced a number of administrative obstacles at the beginning of the project due to some urban regulations in effect in the chosen project area. This situation ended in the official rejection of the project by the Chilean Ministry of Housing and Urban Development owing to the conflict between the project and the urban development plan for the project site.

As a result, the foreign investor resorted to the International Centre for Settlement of Investment Disputes (ICSID), on the basis of the Bilateral Investment Treaty for Investment Promotion and Protection executed by Chile and Malaysia in 1992, which provided for this type of intervention.

The ensuing controversy gave rise to an interesting analysis by ICSID of the importance and necessity of making compatible the rights of a member economy to adopt any sovereign decision in affairs of economic policy as it may see fit, with strict adherence to international treaties that it may have entered into with third economies, with the exclusion of possibly discriminatory measures against a foreign investor.

The case highlights the inordinate duration of the arbitration proceedings which ensued. The proceedings had been going on for close to seven years and the issues were still unresolved. This condition was inconsistent with the expeditious decision-making process that international trade required in order to accelerate the development of the economies involved.

The background and conclusions contained in this case will help to further the aims of the APEC Project, i.e., to promote and facilitate foreign investment processes among the entrepreneurs of APEC member economies.

The Historic Evolution of the Chilean Juridical Framework in the Context of Foreign Investment Promotion and Protection

Until the mid-1960s Latin America was favorably disposed towards foreign investment and regarded this type of investment in much the same manner that it did domestic investment. Chile was no exception to this rule and during the same period the economy enacted major legal provisions designed to encourage the inflow of foreign capital.

In 1954, Chile created the Foreign Investment Committee (*Comité de Inversiones Extranjeras)* and in 1960 it established the Foreign Investment Statute *(Estatuto de la Inversión Extranjera*), thus providing substantial benefits in favor of foreign investment, a move which at that time was a highly significant step forward in this area.

At the end of the decade the above liberal scenario changed abruptly and an open “economic xenophobia” arose against the admission of foreign capital to the Latin American Region, characterized by strict controls on foreign currency operations and a number of restrictions

on imports of various items other than essential goods. One of the clearest instances of the situation described was the approval in 1971 by Bolivia, Chile, Colombia, Ecuador and Peru (all at the time members of the Cartagena Agreement), of Decision 24 of the Andean Agreement, which, among other restrictions, strictly limited the participation of foreign capital in the assets of domestic corporations of the members, and further restricted remittance of profits abroad, import of technology, or use of foreign trademarks and patents.

With the advent of a military administration in Chile (1973-1990), the above inordinate protectionist position was reversed and a new Foreign Investment Statute was adopted in 1974 with the stated objective of promoting foreign investment. A number of restrictions that hampered foreign investment were lifted, which led to the withdrawal of Chile in 1976 from the Cartagena Agreement as well as from the Andean Agreement.

From that time on, a solid legal system tending to foster free trade and foreign investment and guarantee the security and freedom to export the capital invested and the profits obtained, had taken shape in Chile. It was implemented with the enactment of various economic laws designed to protect the ownership of foreign investors in the event of abusive or illegal expropriatory acts by the Authorities.

In contrast with the protectionist attitude that prevailed in Latin America, the more highly developed economies—principally Europe and the USA—endeavored to structure the bases of an international protection system in favor of their corporate nationals' investments abroad. This was done to ensure the remittance of capital and profits, and to protect them from risks of a nationalist nature, whether in the form of expropriations or restrictions to the free exercise of their business operations.

Such concern took shape in various international agreements, namely, the bilateral free trade agreements, investment promotion and protection agreements, conventions to avoid double taxation, multilateral instruments for settlement of international controversies, and in diverse institutions designed to insure the nationalist risks described above.

Many Latin American economies, particularly Chile—a pioneer in this regard, including the unilateral opening of its economy—successively adhered to the new attitude, as shown by countless bilateral or multilateral treaties executed to strengthen free trade and protect foreign investment, in the event of threats from arbitrary acts of the administration of the host economy.

It is worth stressing that as of August 2008, Chile has executed with sundry third economies more than 50 Investment Promotion and Protection Agreements (APPIs) and more than ten Conventions, including one with Malaysia, to avoid double taxation. In addition, Chile was a party to a number of free trade agreements, i.e., with Canada, Central America, the European Union, Korea, Mexico, the United States, and the European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland), Chile being also a member of the International Center for Settlement of Investment Disputes (ICSID) and of the Multilateral Investment Guarantee Agency (MIGA).

Features common to most of these international agreements included foreign investor protection, assurance of fair and equitable treatment, non-discrimination *vis-à-vis* domestic enterprise, authority to invoke the most favored nation clause that Chile applied to third economies, and provision for a regime governing settlement of controversies with the administration of the host economy, in a technical, impartial and expeditious manner.

The above description illustrates the protection system in force in Chile regarding foreign investments as embodied in the above domestic laws and international treaties, which formed

part of its legal system. This was a major consideration on the part of the investor from Malaysia in deciding to undertake its capital project in Chile.

The Agreement for Promotion and Protection of Investments (APPI) Executed by the Governments of Chile and Malaysia

As discussed previously, there had been substantial effort on the part of Chile favoring the inclusion under the international legal framework of a number of regulations designed to foster foreign investment in the economy through such mechanisms as, *inter alia,* insurance against non-commercial risks whether of political or expropriatory character, and the execution of various agreements designed to protect such investments and avoid double taxation.

To pursue this direction, the Governments of Chile and Malaysia executed an Agreement on Promotion and Protection of Investments (APPI) in November 1992. Owing to the prolonged constitutional ratification formalities surrounding international agreements of this nature, the APPI took effect only on 4 August 1995. This international agreement contained some provisions which later on proved to be relevant to the Malaysian project in Chile.

For instance, the introductory statement declared that one of the objectives of the Agreement was to create *"favorable conditions for the investments made by investors from one Contracting Party in the territory of the other Contracting Party"* and recognized *"the need to protect the investments of investors from both Contracting Parties..."*

Then, Article 2 para. 2 stated that *"the investments of investors from either Contracting Party shall be granted at all times fair and equitable treatment and shall enjoy full protection and security within the territory of such other Contracting Party."*

Attention should also be given to Article 3 on the Most Favored Nation Clause, which read as follows: *"the investments of investors from either Contracting Party within the territory of the other Contracting Party shall be given at all times fair and equitable treatment, no less favorable than that granted to the investments made by investors from any other third State."*

Competent Jurisdiction to Hear a Controversy Arising between an Investor from Malaysia and the Republic of Chile

Article 6 of the Agreement between Chile and Malaysia dealt with a system for "Settlement of Investment Controversies between one Contracting Party and an Investor from the other Contracting Party", and for such purpose provided that *"... any controversy arising between one Contracting Party and an investor from another Contracting Party involving: an obligation entered into by such Contracting Party with such investor from such other Contracting Party in respect of an investment made by such investor; or an alleged breach of any right granted or created hereunder in respect of an investment by such investor, shall be submitted to the International Centre for Settlement of Investment Controversies through reconciliation or arbitration."*

This provision was based on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States 1965, otherwise known as the IBRD

Washington Convention, open to execution by the members of the International Bank for Reconstruction and Development and effective as of 14 October 1966. The Republic of Chile executed this Convention in 1991 and the Chilean National Congress gave its official approval in January 1992.

Since then the ICSID had been providing foreign investors with arbitration and reconciliation procedures for settling the disputes with the host economies receiving the investment in question. The process involved specialized competence, given that it could hear only juridical disputes arising from a foreign investment. Furthermore, and more importantly, the parties were bound to recognize such arbitration awards as though issued as definitive rulings of their own courts, without requiring *exequatur* procedure for compliance.

Pre-Investment Formalities Entered into by MTD Equity, Initial Approval of its Investment Application, and Subsequent Rejection by the Competent Authority of the Construction Project

Amidst the favorable and friendly environment enacted in the framework of Chilean public policy, a foreign investor, MTD Equity Sdn (MTD Equity), a corporation organized in Malaysia, attempted to carry out an urban development project in Chile between 1996 and 1997 with the objective of building a town on 600 hectares of rural land located in Central Chile, and involving a planned investment estimated at US$ 17.136 million.

Beginning in 1994, the representatives of MTD Equity and certain officials of the Malaysian government held meetings with various authorities and business leaders of Chile, particularly with a representative of the company owning the above-mentioned rural land, to coordinate and implement the project.

As a result, the MTD Equity submitted to the Chilean Foreign Investment Committee (CIE) the required investment application, which was approved by the agency on 3 March 1997. The approval expressly stated that the MTD Equity would develop a capital project on rural land located in Central Chile for the "construction of a self-sufficient satellite town including houses, apartment buildings, schools, hospitals, shops, utilities, etc." The appropriate Foreign Investment Agreement was executed by the CIE for the Chilean government, and the foreign investor on 18 March of that year.

It should be noted that the CIE was a juridical person subject to public law, decentralized as to functions, and was the sole body with authority, for and on behalf of the Republic of Chile, to accept the entry of capital from abroad opting for the benefits provided under the Foreign Investment Statute. The CIE was composed of the Ministers of Economics, Development, and Reconstruction; Finance; Foreign Affairs; Planning and Cooperation; the president of the Central Bank of Chile; and the Minister of the area concerned, in the event of investments in areas other than those already represented in the Committee by a Minister.

Notwithstanding the approval given by the CIE, implementation of the project by MTD Equity faced a number of administrative difficulties right from the start mainly because earlier urban regulations designated the property selected for locating the above project as an agricultural zone only, and therefore incompatible with the project that MTD Equity was seeking to carry out. Nevertheless, both public and private sources appeared to have assured MTD Equity that rezoning of the property for urban purposes might be easily obtained if a major foreign capital project were submitted to the Authorities promoting the development

of such area. In fact, the property appraisal conducted by foreign experts retained by MTD Equity was based on the assumption that the land might be developed as an upscale community once the current zoning for agricultural use had been changed.

Despite the seeming obstacle, MTD Equity proceeded to acquire the rights to ownership of the property where the investment was to be located, under the terms and conditions previously agreed with the owners. The company also injected capital into MTD Chile S.A through which the project was to be developed. Simultaneously, MTD Equity proceeded to retain the necessary professional advisory services and apply for the zoning change on the property where the project was to be located which would require an amendment to the Metropolitan Regional Plan of Santiago (PRMS).

Countless meetings were held from April 1997 to November 1998 among MTD Equity and the Minister of Housing and Urban Development, the Minister of Foreign Affairs, the Executive Vice Chairman of the Foreign Investment Committee, other high-ranking officials of these agencies, and the Mayor of Pirque to pursue the rezoning of the property to urban purposes. These steps however proved to be unsuccessful owing to opposition from the administrative authorities responsible for decisions of this nature, and who stated that such a decision was not contemplated in the plan for future development of the area where the MTD Equity project was to be located.

On 4 November 1998, the Minister of Housing and Urban Development definitively rejected the project, officially supporting his decision by citing that the project *"countered the prevailing urban development policy because it is incompatible with the zoning regulations in force for the place where the property of interest to the foreign investor is located."*

Notwithstanding the above rejection, a third Foreign Investment Contract was executed in September 1999 by the Foreign Investment Committee for and on behalf of the Republic of Chile and MTD Equity in the amount of less than US$ 100,000 to provide additional capital to the company organized in Chile for the development and management of the project. The minor additional investment was believed to have sprung from the desire of MTD Equity to increase the amount of cash funds available to the corporation already organized in Chile, for payment of miscellaneous administrative expenses associated with the project. The further approval from the CIE, albeit the official objections already raised against the development of the project by the Malaysian investor, was subsequently justified in the course of the ICSID arbitration by the officers of the CIE, who stated that the role of the Committee *"was strictly limited to approving the inflow of foreign investment funds into Chile, without prejudice to other obligations of the foreign investor to obtain any other approvals necessary for developing its project."*

Because of what transpired, MTD Equity advised the Chilean Authorities in October 1999, that it proposed to file a request with ICSID to resolve the difficulties it was encountering in the context of its project. In June 2001 MTD Equity filed the requisite papers.

Allegations of the Foreign Investor before the Arbitral Tribunal in Support of its Claim and Allegations of the Host Government Receiving the Investment

In its presentation to ICSID, MTD Equity ("Claimants") held that the Republic of Chile had failed to honor its obligation to grant the permits necessary for the MTD Equity investment in Chile to materialize, although Chile, in their own words, *"created and encouraged strong*

expectations that the Project, which was the object of the investment, could be built in the specific proposed location and entered into a contract confirming that location, but then disapproved that location as a matter of policy after MTD irrevocably committed its investment to build the Project in that location."

MTD Equity argued that such non-compliance by the host government should be considered in the framework of international law, primarily the provisions contained in the APPI executed by Malaysia and the Republic of Chile, the main points of which are presented in the earlier section of this case.

It is worth emphasizing that MTD Equity invoked the statement made in the treaty with reference to the *"fair and equitable treatment"* due to a foreign investor, and this treatment might not be less favorable than the treatment given to investors from other economies, thus alluding to the Bilateral Investment Agreements (BITs) executed by Chile and Denmark (effective since 1995) and by Chile and Croatia (effective since 1996), which in the opinion of MTD Equity upheld the obligation of the receiving Party to grant the necessary permits, once such investment had been approved.

A particularly enlightening reference to the latter statement was the provision embodied under Article 3 para. 2 of the international treaty between Chile and Croatia, which read as follows: *"2. When a Contracting Party has admitted an investment into the territory thereof, the latter shall grant the necessary permits pursuant to the laws and regulations thereof."*

The above allegation ended with the statement that the foreign investment concerned was not given fair and equitable treatment by the Republic of Chile because the latter *"impaired with unreasonable and discriminatory measures the use and enjoyment of the Claimants' investment by failing to grant the necessary permits to realize an investment already authorized."*

This attitude of such Party is a breach of the obligations entered into under the Foreign Investment Agreement executed by both parties, adding that the Most Favored Nation (MFN) Clause, contained under clause 3 of the treaty executed by Chile and Malaysia was also breached by such procedure. This last statement referred to the obligations of Chile under the Agreements known as APPIs executed earlier by Chile with Denmark and with Croatia, which if breached would constitute an expropriation of the Claimants' foreign investment, an action expressly prohibited under Article 4 of the treaty executed between Chile and Malaysia.

In turn, the government of the Republic of Chile ("Respondent") disagreed with the plaintiff over the meaning the latter attributed to the approval of their investment by the Foreign Investment Committee, insisting that this body, pursuant to its organic text, simply approved the capital transfer without going into the project details. This accounted for the limited description of the objective of the investment that was required from a foreign party seeking to begin a foreign investment project in Chile and applying for such benefits as the Foreign Investment Committee granted in such cases.

The Respondent added that in the course of various meetings held with the Claimants, there was occasion to advise them that their project was opposed to the objectives of the Metropolitan Regional Plan, *"one of which was to promote urban densification."* In its view, MTD Equity ought to have displayed due diligence prior to investing money and executing various agreements with prospective national partners.

The Respondent reiterated its position regarding the mission pertaining to the CIE to the effect that, pursuant to the terms of the CIE organic text, such mission was solely to *"perform information, registration, statistics, and coordination functions in regard to foreign*

investments" and that neither such organic text nor any other law in force in Chile contained any provision binding the CIE to seek from any other authority a report or prior approval of a real estate project such as the one that MTD Equity had proposed.

In addition, the Respondent argued that the foregoing was supported by national jurisprudence, which had regularly recognized the limited competence of the CIE and the limited scope of Investment Contracts. The Respondent's allegations ended with the statement that, contrary to the Claimants' allegation, the Republic of Chile was under no obligation to advise MTD Equity regarding the feasibility of the project before they commenced the investment.

Decision and Grounds of the Arbitral Tribunal on the Controversy

In the award forwarded to the parties on 25 May 2004, the Arbitral Tribunal designated in accordance with ICSID rules found that the Republic of Chile had breached its obligations under Article 3 of the Bilateral International Treaty (BIT) entered into with Malaysia, which laid down the well-established point of international doctrine known as "fair and equitable treatment." Nevertheless, it also found that the Claimants, MTD Equity, which ought to have obtained due protection from business risks inherent to their investment in Chile, had failed to present adequate proof of having done so.

Based on the above considerations, it sentenced the Republic of Chile to pay the foreign investor the amount of US$ 5,871,322.42, equivalent to half the amount requested by MTD Equity, in damages.

Thereupon, the Respondent appealed for annulment of the sentence, which was denied on 21 March 2007 by an ad hoc Committee composed of three members designated by ICSID. With its ruling, the Committee stated that its role in hearing such appeal for annulment was limited, for it had no power to amend the merits of the decision adopted by the Arbitral Tribunal against which such appeal was raised.

A brief description is given below of the most important decisions and associated motivations contained in the above award, which will provide food for thought to member governments receiving foreign investments in the future, as well as to businessmen electing to invest abroad.

The most important of this was the application by the Arbitral Tribunal of the Most Favored Nation (MFN) Clause, which was provided under Article 3 of the Chile-Malaysia BIT. In this regard, the Tribunal concluded that, under the BIT, *"the fair and equitable standard of treatment has to be interpreted in the manner most conducive to fulfill the objective of the BIT to protect investments and create conditions favorable to investments...",* and further considered to include as part of the protections of the BIT those included in the Denmark BIT and the Croatia BIT *"is in consonance with this purpose."*

On this issue, the Tribunal particularly referred to the Chile-Croatia BIT, which provided that *"the right to fair and equitable treatment* '*shall not be hindered in practice'."* In the same context, the Tribunal further referred to the Commission of the North American Free Trade Agreement (NAFTA), which *"interpreted 'fair and equitable treatment' as not requiring treatment in addition to or beyond that which is required by the international law minimum standard."*

In view of the foregoing considerations, the Arbitral Tribunal declared that it was *"obliged to apply the provisions of the [Chile-Malaysia] APPI and interpret them in accordance with the norms of interpretation established by the Vienna Convention on the Law of the Treaties, which [...] requires that a treaty be 'interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.'"* The conclusion of the Tribunal was that *"fair and equitable treatment should be understood to mean treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment."*

In the same context, the Tribunal agreed with the Claimants' position that Chile, having approved their investment, was bound to grant them the necessary permits for adequate development of their project. The foregoing was based on the Chile-Croatia APPI, which provided that *"[w]hen one of the Contracting Parties has admitted an investment in its territory, it shall grant the necessary permits subject to its laws and regulations."* The Tribunal concluded that such position was fully applicable to the controversy under discussion and had valid juridical support, given the wide scope of the MFN Clause under the BIT.

On the issue of diligence shown by MTD Equity in the planning and development of their Project, the Tribunal considered that Chile was not *"responsible for the consequences of unwise business decisions nor the lack of diligence of the investor",* and specified that *"BITs are not insurance against business risk."* Nevertheless, it pointed out that Chile was responsible *"for the consequence of its own actions"* to the extent that it failed to give the investor *"fair and equitable treatment."*

Regarding the Claimants' complaint that Chile had applied unreasonable and discriminatory measures against them, the Tribunal based its decision on Article 3 of the Chile-Croatia BIT, which provided that *"[e]ach Contracting Party shall protect within its territory investments made in accordance with its laws and regulations by investors of the other Contracting Party and shall not impair by unreasonable or discriminatory measures the management, maintenance, use, enjoyment, extension, sale and liquidation of such investments."* It further concluded that the approval by a host government of an investment against its own urban policy could be considered unreasonable.

It is interesting to note the MTD Equity's claim of indirect expropriation of its investment, based on Article 4 of the BIT and a number of facts: that it made its investment after having been authorized to do so by Chile; that it was forced to halt execution of the project because it was told that it lacked a necessary permit; and that it attempted to obtain such permit but its attempts were rebuffed and as a result it was unable to continue its Project and essentially lost the value of its investment. The MTD Equity alleged indirect expropriation resulting from actions and failure to act by Chile, irrespective of whether the latter intended or did not intend to cause indirect expropriation.

Although the Tribunal was cognizant of such circumstances, the situation was not one of expropriation but an instance of unfair treatment dealt to the investor by Chile by approving an investment that was incompatible with its own policy and ought to have been rejected by reason of internal policies.

Final Comments on the Discussion of a Real Case of Foreign Investment Dealt within the Preceding Sections

Chile has set up a powerful institutional framework of both national and international scope, designed to foster foreign investment in its territory, while protecting the investment from excessive regulations that might hinder the legitimate right of ownership of the proprietor of the investment concerned, and from illegal expropriation.

The successful achievements of Chile in this respect are widely known, as shown by the number of foreign businesses that have completed investments under the legal franchise provisions discussed above as well as the amounts invested. The differences arising between Chile and foreign investors have been minimal and invariably settled through the legal channels agreed with and accepted by the host government of these foreign investments.

The Arbitral Tribunal hearing the controversy discussed in this case recognized as much in its award, noting *"the success of the Respondent in attracting foreign investment",* while recording its *"understanding that a dispute before an ICSID Tribunal is not necessarily a black mark on the record of a country or an investor",* adding that *"[b]ilateral investment treaties are relatively new and it is not unreasonable that their application and the many factors that affect foreign investment be a source of disagreement."*

The case writer shares this objective and impartial outlook, and in a constructive frame of mind one must agree with the principles adopted by the award and that the responsibility of the various member economies is not over by the sole fact of approving a foreign investment and materially receiving it. The host economy must take up additional responsibilities relative to the possibility that a foreign investor might claim that the host economy had the responsibility to grant the foreign investor the permits necessary to implement the project as provided under the Treaty executed by Chile and Croatia. Thus, it is advisable for the Authorities to require first the foreign investor to show or to make sure that such permits would be granted as appropriate. This procedure would further achieve greater coordination among all the administrative authorities concerned.

This is the true meaning and scope of the obligations arising from the international investment treaties that Chile has executed, and also the spirit of its current Constitution regarding freedom to undertake any legitimate activity and assurance of the right of property over such investment.

Hence one has to agree in general with the reasoning of the ICSID Arbitral Tribunal that *"approval by the CIE of a foreign investment for a project that counters the urban policy of the Government is a breach of the duty to dispense to a foreign investor fair and equitable treatment."* Such treatment may not be less favorable than that afforded to investments by investors from any third economy, as in the case of the International Treaty between the Chilean and Croatian Governments.

In conclusion, it is worthwhile noting the operation of the ICSID system for settling disputes, from the standpoint of the case of MTD Equity.

The complaint addressed by MTD Equity from Malaysia had been going on for almost seven years, with no concrete results as of June 2008 regarding recovery of the damages that the Tribunal decided should be paid. This was a result of lengthy procedures to deal with issues such as the resignation of judges and presentation of a recourse for annulment of the award.

There has been a substantial increase in the number of cases brought before ICSID lately, in spite of the relatively scant jurisprudence that might be derived from such cases. The legal

costs incurred by the parties in defense of their interests had been high, including the costs of retaining highly competent foreign law firms, mostly from Europe and the USA. It is suggested that Latin American economies such as Chile make efforts to train teams of young professionals who might participate and cooperate on issues of this nature with more experienced persons. It is commendable that ICSID for its part continues to discuss its own procedures and promote the needed reform whenever advisable and arrived at by consensus.

Setting up a Factory in China: Sanyan Steel Co., Ltd

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This case was developed based on the personal experiences of the casewriter, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). Names and other identifying information in the case are disguised. The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

In 2001, Sanyan Steel Co., Ltd, the world's number one producer of B-grade special quality steel used for the manufacture of auto parts decided to put up its production facility in China to serve its mostly Japanese client companies which were already based in that economy. While the move was a strategic business decision for Sanyan, the ensuing locational and operational problems that Sanyan's China-based company and its president, Nakamura, experienced, highlighted the difficulties that investing in a foreign economy like China entailed. As Nakamura found out, investing in China meant understanding and embracing its culture, its business practices, and its people.

This case describes what it takes for a company like Sanyan to succeed in a foreign business environment. It underscores the need for foreign investors to recognize and accept diversity and to adapt and work within the given environment, without sacrificing the quality, productivity and professionalism of the enterprise.

Introduction

In recent years, almost all major global passenger car manufacturers have invested in the growing China market and have set up manufacturing facilities there. To serve the final assemblers, many auto parts manufacturers have also been establishing production lines in China, so that the auto assemblers could localize their parts manufacturing operation and achieve higher local content in the China market.

Sanyan Steel Co., Ltd was the world's number one producer of B-grade special quality steel, a key input to the manufacture of auto parts. Instead of supplying hot rolled steel bars to the parts manufacturers, who in turn shipped them from Japan to China, Sanyan Steel decided in 2001 to establish its own forging plant in China to supply their client companies forged products and help them achieve higher local content.

Key Reasons for Deciding to Invest in China

As the Japanese auto makers moved their production overseas, many suppliers—not only "Tier one" but also "Tier two" parts makers—were expected to follow suit. Sanyan's traditional business model was to supply materials to Japanese domestic parts makers. However, as a result of the shift of the company's clients towards overseas production, Sanyan-supplied materials were increasingly being exported overseas by Japanese clients, to be used mainly in their overseas plants.

This development created a business risk both for Sanyan and for its clients. As an exported commodity, the selling price of Sanyan's steel in the local currency fluctuated with the movement of foreign exchange rate *vis-à-vis* the Japanese yen. One of the main reasons why Sanyan Steel needed to set up a plant overseas was to respond to the clients' desire to minimize the risk in foreign exchange rate fluctuations between the Japanese yen and the local currency. Likewise, Sanyan had to meet the needs of the auto manufacturing companies to increase the local content ratio in their overseas operations such as those in China, where

the central government required a higher local content ratio year-by-year from manufacturing companies.

Site Selection

To meet the twin goals of minimizing price fluctuations caused by exchange rate movements and increasing local content, Sanyan was compelled to build a production facility overseas. In choosing the location of their plants, the company had to consider three basic options based on transport costs and other logistics considerations: a) proximity to the supply point of raw materials, or b) proximity to the clients' plants, or c) proximity to both the supply point of raw materials and the clients' plants.

Since the company's major clients were located in the growing passenger car production points in Bangkok, Thailand and China, they would have to bring their raw material supplies from Japan for the time being. But Sanyan expected to replace these with locally-supplied materials in the future once satisfactory quality standards had been achieved. Thus a key consideration in Sanyan's choice of location for its plants was the presence in the locality of steel mills standards, which had the potential to achieve the appropriate quality. While there was no special steel mill with acceptable quality in Thailand, there were some in China. Thus Thailand was effectively ruled out as a potential investment location, leaving potential locations in China as the viable options.

The Chinese car industry was concentrated in the three major industrial areas of China, namely, Northern China (Hua-bei area, e.g. Tianjing), Eastern China (Hua-dong area, e.g. Shanghai) and Southern China (Hua-nan area, e.g. Guanzhou). Taking into account additional factors such as density of population, economic growth potential, rate of modernization, infrastructure improvement and globalization, Sanyan considered the Hua-dong area, which included Shanghai, as the best potential location in China for its investment.

Sanyan thus decided that its plant should be in the suburbs of Shanghai, in a place called Ningbo City, located on the other side of Hangzhou Bay where there was a plan to construct a new bridge. It would take only two hours drive by car to reach Ningbo from Shanghai City center once the new bridge had been completed, compared to four to five hours via the existing highway.

Another important point in favor of the Ningbo area location which made it extremely competitive was its accessibility to the port at Beilong, the second largest major industrial port in China and the most accessible for container freight from Japan. The location would make it possible to design Sanyan's new facility based on the potential future export business of up to approximately 85% of total revenue. In Sanyan's business, a good access to a container shipping port was very important to save time and money.

Steel-Making Technology and its Implications for Sanyan's International Business Experience

There were two major methods of steel making, one by melting steel scrap by using electric furnace, and the other by extracting iron from iron ore by using a blast furnace. Production

of steel using either method required a continuous production process and the maintenance of a level of output. Of the two methods, however, the traditional blast furnace required a longer time frame of continuous production lasting at least 15 years or more.

Blast furnaces never stopped running until such time when their inner refractory bricks needed to be replaced. In contrast, an electric furnace could easily suspend its operation, making it more flexible and capable of providing a shorter payback period for the investment. As a result of this fundamental difference, steel mills with electric furnace system could adjust production volumes more easily in response to a market slowdown. On the other hand, traditional steel mills using the blast furnace system had to devote much attention and effort to maintain production quantity. Thus all the blast furnace steel mills considered export as an important company strategy.[1]

Sanyan steel was one of the electric furnace steel mills producing mainly for Japanese domestic customers. Hence, not many people in the company had experience in the export business and only a few managers spoke English. Every time the company needed to appoint staff to an overseas office or subsidiary, it had to rely on outside recruits to fill up the position. In short, the Sanyan company was not very familiar with overseas operations when it embarked on its investment in China.

Chief Project Leader

In selecting people for overseas assignments, it was common practice in Japanese companies to choose engineers with strong technical background who might not necessarily have a background in marketing or knowledge of the cross-cultural dimensions of international business. But it was also quite common to select a non-technical manager who was not familiar with the engineering aspects. The ideal set-up would have been that of a top management team with complementary skills and experience, for example, to have a president with an engineering background and a vice-president with business and management experience, or vice versa.

Keisuke Nakamura had varied experiences in different fields. He took science courses at the university but had been working in the business development department of a trading company for 31 years. While working with the trading company, he was involved with trading-related positions like buying and selling for 10 years or so. The rest of the time, he was busy setting up new companies or operating joint venture companies and coordinating new joint ventures. Nakamura had two previous work assignments overseas, one as vice-president for a wire drawing company in Vancouver, Canada, and another as vice-president in a steel processing center in Shanghai, China. Both companies were subsidiaries of steel mills and Nakamura spent four years each in these joint ventures.

One member of the top management team who was responsible for initiating new investment projects within Sanyan knew Nakamura since 1989 and had been providing overseas information that Nakamura requested. He decided to ask Nakamura to leave the trading company and join Sanyan as the president of the new plant in China.

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[1] In the case of market downturns, blast furnace steel mills often promoted export business aggressively to maintain production volume, which was why anti-dumping measures were so common in the steel business.

First Steps at Sanyan

To Nakamura, accepting the offer was a critical decision in his business career. There were many cases of people from the steel industry joining a trading company, but to his knowledge it was very rare for a person from a trading company joining a steel mill. The offer came at a time when Nakamura was thinking of leaving the trading company to establish his own business. If he accepted Sanyan's proposal, he would have to postpone establishing his own company. He weighed carefully whether to accept the offer or not. It was a serious decision that he had to make.

Nakamura's management experience in operating companies in the past was both in his capacity as vice-president. He realized it would be helpful to become the president of a company before establishing his own company. He needed to see how tough it would be to judge everything himself and to be ultimately accountable for decision-making. Moreover, he did not know the key aspects of steel manufacturing such as production cost structure, and he knew it would be worthwhile to gain this type of experience for the sake of his own future business. Nakamura accepted the offer and joined Sanyan Steel Company in February 2001.

Nakamura knew that one critical success factor was to first create a strong management team. Whatever he did in China, it would not be possible to do it all by himself. Thus right after he joined Sanyan, Nakamura visited his old Chinese friends from his stay in Shanghai in the past, and recruited three persons to join him in setting up the new company in the Ningbo area. The three new recruits and Nakamura constituted the core members of the new company, and they worked well together.

In setting up an overseas joint venture company Nakamura's basic policy was to establish it in an area where people from the Japanese parent company would be willing to live and work. The environment had to be good, the location safe and convenient for shopping and recreation, with good schools, health care and other facilities. In contrast, in deciding on the location, the management of Japanese companies generally placed more weight on economic factors like the availability of low-cost land and labor, the risk of natural disasters like floods, and other aspects of the cost of doing business. While these aspects were important, Nakamura knew that one should not discount the importance of the quality of life that would keep the Japanese expatriate staff mentally and physically healthy while working overseas. Later on Nakamura found out that a nice environment was really important not only for the Japanese expatriate but also for the local staff in China.

Sanyan Steel had decided to build its plant in a very isolated area which was far from downtown Shanghai. Nakamura had argued to top management that a particular industrial development zone prepared by the local government authority was a suitable location that could attract many capable people to join the company. But the senior management in Japan gave more importance to locating the plant near the Chinese partner.

It was rather easy to recruit shop floor work force so long as accommodations were provided by the company. However, engineers, accountants, and capable sales people did not want to live in the countryside. They said that if the company would force them to live in such a remote area, the company would have to pay them higher salaries as recruitment bonus to compensate for the remote location. This aspect of the Chinese labor market was very different from what Nakamura had experienced in Japan. He was somehow shocked to hear these comments. But it was necessary to accept the practice in order to recruit capable staff.

Working and Living in China

In Japan, it was generally understood that even when the decision-making authority was delegated to the staff, the latter was expected to undertake business within the well-defined scope of corporate policies and consistent with the corporate culture or the manner of doing business in that company. In general, this clear delineation of authority was not the norm in China. Many Chinese working for a company would say that once authority was given to them, it was up to them to do business in whatever manner they wished as long as it resulted in profits for the company. If a superior gave instructions for a task different from what they believed should be done, they tended to express their disagreement by saying outright that they would not do it and that the superior should do it himself. Other times, they would agree to do as instructed but would not accept responsibility for whatever went wrong.

Delegating authority in Japan did not imply a full transfer of the decision-making power, but instead allowed the staff to implement the business plan step-by-step without re-approval of tasks at every step, as long as the plan was carried out in accordance with company policy and rules. This system required a high degree of alignment with the company's practices and policies. Hence, business had to be executed in much the same manner as if the boss had done the task himself. While there was room for some individuality of style, the policies and strategies had to be followed.

At the beginning of his previous assignment in China, Nakamura used to argue with his Chinese staff. But he realized that it might be the Japanese who were unusual in their approach to work and employment relationships and that the more individualistic way of thinking of the Chinese might be more typical. For example, he knew that Japanese shop floor workers in a manufacturing plant usually worked very hard and thought of how the job could be done differently to improve production efficiency or to produce better quality products to meet corporate expectation. They sometimes worked overtime even without overtime pay. And they did not complain about low wages even if they knew that the salary of the president was much higher. They accepted the situation because they respected the president's position in the company.

Nakamura began to realize that people across the world did not work without pay. How hard they were prepared to work depended on the rules governing their employment. In case of individual effort, additional pay would be expected. Shop floor workers generally did not aim to become president of the company in the future. Nakamura thought this was a more logical arrangement than the Japanese way.

An incident took place which further strengthened Nakamura's belief that the Japanese way was different from the Chinese way. A Japanese staff member on a temporary assignment came to the plant in China to help with some engineering work. He kept his wallet and passport in his desk drawer just as he would have done in Japan, in spite of the many warnings he received from Nakamura. He went to the plant for several hours, and when he came back, his wallet and passport were gone.

The police was called. He came and interviewed people, then left. Nakamura wanted to know when they could expect to find the criminal. The police did not provide a definitive answer citing that it was nearly impossible to find the criminal among the millions of Chinese saying, "How many people do you think there are in China? Do you know?" He instead reminded Nakamura that it was the responsibility of the Japanese staff to take care of his belongings and not to leave them for "a hungry guy to eat." Nonetheless, he informed Nakamura that he wrote the police report so that the Japanese staff could apply for insurance.

Nakamura fully understood the reality of the situation then. He agreed with this policeman completely.

Nakamura also decided to make it the corporate rule in China that no Japanese staff or his family would be allowed to drive a car during their stay in China while on company or personal time. He had heard from Chinese friends several times that there were some people who intentionally hit a nice car driven by a foreigner in order to negotiate for money. Thus even if one were to drive carefully, it might not be safe to drive a car in a foreign place. Such incidents happened throughout the world, and it was better to avoid this potential trouble while living and working in China.

Relations with Local Government Agencies Related to Regulation of Foreign Investment

How to Deal with Local Government Agencies

It was a generally understood common practice in China for people to wait a long time to get an authorization from the government agencies to do anything. But Nakamura's experience was that clearances could be obtained fast in cases where the people in the government offices wanted something in return, in the spirit of what might euphemistically be called "reciprocity."

Responding appropriately worked anywhere in the world, but it took some experience to discern what the people they were dealing with wanted in return. After learning about this practice, Nakamura always tried to find out if there was anything that the party he was dealing with wanted, as the following examples illustrate.

Regulation of Foreign Investment, Local or Central

In order to register a new joint venture company in China, it was convenient to establish the company with a total authorized investment amount of less than the threshold requirement of US$ 30 million, which could be approved by local government at the province level. Thus Sanyan established its joint venture with a total investment of US$ 23 million. However, due to additional requirements, the company needed to increase the total investment amount to roughly US$ 43 million. Application for investments exceeding US$ 30 million must be forwarded to the Central Government in Beijing after provincial approval was obtained, which took a long time.

Serious Need for Urgent Authorization

The application needed to be authorized within two months because of the deadline set for the final completion of Sanyan's production line. All other members of the management team doubted that the approval could be available within the two months, but Nakamura thought he had to get it by all means. He visited the vice-mayor, who introduced him to a lady manager in charge of foreign trade and economics. Nakamura explained to the lady manager how critical the situation was and how important the project was for the automotive industry in China, inasmuch as the auto parts production from this new line were the

important inputs to the new car model which was being developed by a Japanese auto manufacturer in China.

How to Clear Up the Difficulties

Nakamura sent his Chinese colleague to the lady manager's office the following day and let him try to persuade her to cooperate by all means, but it was in vain. Nakamura insisted that his colleague should go back to the lady manager's office everyday until she agreed. Five days later, she finally introduced the Chinese colleague to the general manager in charge of relations with the Beijing Central Government in the local government. This general manager suggested that the Chinese colleague visit Beijing with him. While the real motive for this suggestion was not very clear, Nakamura had no other choice but to agree.

When Approval Granted, a Small Request in Return…

Two weeks later, the additional investment was approved by the Beijing Central Government, and everything was done. On Monday morning following the approval, Nakamura visited the vice-mayor's office and expressed his sincere appreciation for the splendid cooperation of the local authorities. Then the vice-mayor said that he had one request. He said there was a very important convention in Guangzhou in which many Taiwanese and Hong Kong businessmen would be participating. The vice-mayor was scheduled to make a speech on the attractiveness of his city and how the local government cooperated with foreign joint venture companies. He requested Nakamura to also deliver a supportive speech at the same convention in front of more than 600 people. He had already prepared a draft of the speech and he told Nakamura that he could just read it. Nakamura readily agreed.

Clever Approach

As the host local government for Sanyan, the vice-mayor provided services that were of utmost importance to the company. The vice-mayor must have planned right from the start that he would join the convention together with Sanyan's representative who would attest to the support of the local government and the attractiveness of the city as an area for establishing new factories. He believed that Sanyan's representative would definitely agree to his request based on their close personal relationship.

Nakamura concluded that it was very important to know what people were expecting him to do for their benefit, so that he could respond in an appropriate and ethical manner.

Difference in Business Cultures as Related to Construction Contracts

The Challenge of the First Building

The land area for Sanyan's new factory was 60,000 square meters and the management had planned to construct nine buildings one by one, based on authorized written contracts. There were many buildings in a big city like Shanghai, which made use of H-shape steel structure,

but Sanyan was located in the countryside in Ningbo city. The local construction company was not familiar with modern building techniques using H-shape steel structure. Considering the time it would take for the construction company to learn the technique, Nakamura decided to go ahead with the conventional Chinese building method, but only for the first building. Thus the company gave the contractor time to learn the H-shape method that would be used in subsequent structures.

Imminent Problem

One day in March 2002, an internal management meeting was held at the head office of the Japanese parent company. The senior managing director of the parent company told Nakamura in front of about ten concerned people that there was not enough time before the planned production start-up. He said that the first plant building must be completed on or before the end of September that year. He asked in a loud voice "Are you okay with the deadline?" Nakamura had no choice but to say, "Yes, sir." The senior managing director clarified and confirmed the commitment, asking, "Are you serious?"

There were only six months left, and the factory had to be available for production. It was necessary to complete the plant construction as quickly as possible despite the arrangement made with the contractor to allow them time to develop the necessary expertise.

Nakamura consulted with Wang, the general manager of the local construction company, on how to overcome this problem. Wang mobilized all resources and accomplished the construction within the specified timeframe. The people concerned were very happy and from then on the construction company and Sanyan developed a much closer relationship with each other.

The first contract with Wang covered only one building. Nakamura decided to place the order for the other buildings with Wang based on his track record. Later on, Nakamura found out that the delivery of the first contract was a kind of "gift" from Wang in order to land the other contracts.

The Way to Make Money as a Construction Company

Although contracts for each building construction were separate and could be placed with companies other than Wang both logically and legally, it was not convenient for more than one construction company to work on the building site. It was easy to imagine frictions arising between two parties. It was thus decided to place all contracts with only one company on a continual basis. However, Sanyan did not commit all of the business at one time to maintain some leverage against Wang in the event of his company's non-performance. For his part Wang kept raising the unit price of every subsequent building contract gradually, because he also realized that the Sanyan management would not place new orders with another company.

Serious Labor Problems Developed

Wang came to Nakamura's office again and again asking for installment payments. Nakamura issued a check for an appropriate amount of money so as not to stop construction work. Wang was not happy with the progress payments, and finally he stopped paying wages to the construction workers, telling them that he had no money because the Japanese management was not paying the full amount of money according to the contract. He did this

on the exact day when some important European clients were visiting the company. At the precise time that the clients were having a plant tour, the Sanyan manager for general affairs came to the plant and reported to Nakamura that a huge number of construction workers were at the office protesting. People were shouting, “Pay us money, pay us our wages.” Nakamura rushed back to the office and told them that the company had already paid the full amount to Wang to cover cost and wages. Nakamura explained that what the company had not yet paid in full was the portion of the amount corresponding to Wang’s profit, because it was too expensive and had not yet been mutually agreed on. The labor representatives understood and went to Wang’s office, thus clearing up the difficulties. The tense situation had eased before the European clients went back to the office.

Contracting in Different Business Cultures

In other economies, it was generally understood that once a construction contract was signed, the construction company would try to keep to its terms. If something went wrong and the situation could not be managed, the contractor usually consulted with the owner on how to address the situation. However in China, when a construction company signed a contract, it was usually viewed simply as a guideline. Once the job was completed, a third party oversight committee examined the results of the construction work both from the engineering and monetary aspects. If the third party oversight committee assessed the results as reasonable, the owner was obliged to pay the amount indicated even if the project had accumulated a huge cost overrun. Cost overruns rather than savings were the norm.

There could be a number of reasons behind these practices. Prices of construction materials in China were not very stable, and it would be imprudent for a contractor to assume this risk in preparing a fixed budget. Given China’s booming economy, materials scheduled to be used were often sold out by the time they were needed according to the construction plan.

Many foreigners considered this practice as bad behavior on the part of Chinese construction companies, but Nakamura considered it just a different way of doing business. He believed that it was necessary to understand business norms well in advance before negotiations with a construction company commenced.

For instance, the contractor should have indicated in the contract sheet that the prevailing price of the item was meant only as a guideline with the provision that the actual price would depend on the market price at the time of usage. Alternatively, the construction company could secure the materials at the prevailing rate. However, what happened was that most of the time, the contract was signed and the actual price charged was the price at the time of purchase.

Another issue was the working relations between the construction company and equipment suppliers. While the construction was still going on, equipment makers could start installing their products. Unless this process was well managed, the construction company might not provide enough space to allow the equipment installation. Indeed fights between construction and equipment installers were not uncommon.

It was necessary for Nakamura to intervene and request the manager of the construction company to allow the equipment supplier to do the installation job. The construction company agreed only after receiving Nakamura’s formal request.

Later on, however, Nakamura found that the construction schedule started to slip. Asked about the reason for such a delay, Wang explained that it was due to the machine installation. Nakamura was frustrated. If that were the case, he expected Wang to inform him of the

possible delay. He then realized that he should have understood the mentality and work culture he was dealing with before he became frustrated.

Technical Expertise and Knowledge of Dealing across Cultures Is Necessary to Set up a New Company in another Economy

Importance of Nakamura's Prior Experience in China

Sanyan Steel Japan was a steel mill. There were many engineers but not many managers who were familiar with overseas operations. Many of the company's clients were in the Japanese auto industry and were aggressively trying to capture their share of the Chinese market by competing with American and European companies. Sanyan had decided to set up a plant in China in 2001, but found out there was no suitable key person internally to lead the project. Thus they decided to recruit Nakamura to take on this role.

As noted earlier this was the third overseas assignment for Nakamura. The first was in Canada from 1983-1987 as the vice-president of a company, which meant that his role was to oversee the whole organization. The second assignment was also as vice-president, but it was in China. It was an extremely tough job in Shanghai. The joint venture partner was the state-owned giant steel mill. The president came from the Chinese partner, and everyone else in the company of approximately 200 persons was Chinese. Nakamura had no experience working, living or even visiting other Asian economies including China. He could not speak the Chinese language at all. He had to rely on a Chinese translator who worked with him for the whole four years he was in China. Another of his colleagues was the driver of the company car. These employees were an integral part of Nakamura's life in Shanghai; without their help, Nakamura could not do anything in China.

Nakamura considered the experience he acquired during the four-year assignment as critically important for the new assignment to head Sanyan's joint venture. He was able to avoid many similar mistakes and troubles at Sanyan, thanks to his earlier experience in Shanghai.

Succession Planning

When Nakamura decided to join Sanyan in Japan in 2001, he made up his mind to return from China to Japan as soon as the company start-up phase was successfully completed; that is, after he had completed the construction of the factories, hired people, established the rules and procedures for the new company, overseen the installation of equipment and established good relations with Chinese banks, with the main customers and with the nearest customs office. In other words, he planned to lay the groundwork, except for the production and engineering aspects, which were not his expertise. However, just before his planned return to Japan, the Severe Acute Respiratory Syndrome (SARS) crisis broke out in China, which delayed the original time schedule by at least six months. Eventually Nakamura returned to Tokyo in 2004.

The management of the parent company proposed to select Nakamura's successor from among four candidates who were all former trading company employees. Based on their bio-data, Nakamura decided to interview one candidate, Yamada, who had much more

experience in China than Nakamura himself. After a three-hour meeting in Tokyo, they came to a mutual agreement to work together.

Right after the parent company hired Yamada as Nakamura's successor, it became obvious that quality control and production efficiency were not within acceptable standards at Sanyan's Chinese plant. Because of his lack of technical background, Nakamura could not address these issues immediately. Considering the technical problems involved, the parent company decided to assign as Nakamura's successor an engineer who was expected to solve them as soon as possible. Thus with regret, Nakamura was obliged to ask Yamada to accept the position as vice-president, instead of as president of the Sanyan plant in China.

As noted Nakamura was not a professional engineer. At first he thought that he would understand some of the engineering issues based on his university education. However, in practice it was not easy to address the technical issues without the input and strong cooperation of the engineers from the parent company. It required the full support of the parent company to effect the transfer of technical expertise to the China operations, but as a non-engineer Nakamura was not able to fully avail of this technical support. It was only in 2007, more than three years after Nakamura's departure from China, that the Ningbo plant started to run well, thanks to the efforts of everyone.

The Importance of Trusted Friends

Nakamura completed his assignment in China without major difficulties except for quality control and productivity. He attributed his success to the presence of his true friends whom he could trust and from whom he obtained guidance. His friends acted as his eyes and ears who kept him informed of what was happening within the company; what could go wrong among people in the company; how local government was reacting; how well the construction job was going; whether there were anomalies in the company; whether lunches the company provided were popular; and so on. The management of many similar Japanese operations experienced troubles, problems, mistakes and monetary loss. Having trustworthy friends in operations was not common, but it was extremely useful in avoiding pitfalls.

What Is Most Important for Success in Other Economies?

Reflecting on his own experience Nakamura has drawn a list of items which he thought were key success factors (See Box 1). While on the surface these pieces of advice appear simple, in fact they are complex, multi-dimensional and subtle in nature.

One additional piece of advice that Nakamura offered was that one should try to take it easy as much as possible. If one were to take everything too seriously, it would become more difficult for him and he might lose sight of what was important.

It was interesting to note that the Chinese friends and colleagues of Nakamura sometimes said that his way of doing business was more Chinese in style than that of the Chinese. But when they said that, they always smiled, saying, "Are you really a Japanese?"

Box 1 Advice for Expatriate Managers

First, you need to acknowledge that each economy is different from your own. Thus you need to change your mind and admit that the same approach that you have used at home may not be applicable.

Second, people's desire in other economies may not be the same as yours. This can be said even in the field of religion, way of living, pleasure, mental health, vanity and so on.

Third, please do not say that democracy is the best. There are many types of democracies, and people in other economies may have different things in mind when they use the term.

Fourth, please simulate people's way of thinking so that you can understand why they are doing what they do, and why.

Fifth, please prepare multiple options from which people can choose what is best for themselves, so that they can understand that the outcome is at their own discretion.

Sixth, whenever people ask questions in any field, please answer them right away so that people can react right away and consider that you are capable.

Seventh, please do not complain about people's accidental mistakes but just suggest that they should correct them accordingly. People need to learn from their mistakes in order not to repeat them.

Eighth, please praise people when you find something good. Words of praise always make people feel positive and encouraged to contribute more to the company.

A Test of Many Wills:
PT Asuransi Jiwa Manulife Indonesia

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Executive Summary

This case concerns the well-documented experiences of the Indonesian affiliate of Manulife Financial, a Canadian life insurance company, during the early years of the current decade. Manulife's forerunner, The Manufacturers Life Insurance Company, had operations in Asia, including Sumatra, from about the turn of the twentieth century. The group's current operations in Indonesia began in 1985, however, through a joint venture called PT Asuransi Jiwa Dharmala.

In 2000 Manulife Financial attempted to buy out the interest of its Indonesian partner, the Dharmala Group, a second-generation, family-controlled Indonesian conglomerate that began as a trading company and more recently expanded into financial services. The group was very highly leveraged and had found itself in considerable difficulty following the Asian financial crisis. By 2000 its major non-bank arm, Dharmala Sakti Sejahtera, was bankrupt.

The result of Manulife's buy-out attempt was a protracted legal battle and test of wills that became exceptionally nasty by the normal standards of resolving business disputes, whether through litigation or negotiation. As events unfolded, a Manulife Asuransi Jiwa Dharmala company executive was jailed, and the Manulife affiliate itself petitioned into bankruptcy and temporarily closed. The credibility of both the Indonesian legal system in general and its process for restructuring financial institutions in particular were called into question in many developed economies. On the other hand, Canada and Manulife were accused by Indonesian observers of abusing their powers.

The case provides a number of lessons learned that are of relevance to the APEC process, including the inherent complexity of resolving complex commercial disputes; the importance of developing effective, transparent rules-based legal frameworks; the need for investors to understand the environment in which they choose to do business; the power of public scrutiny as a force for change; and the payoff from professional crisis management. Although the situation has largely been resolved in Manulife's favor, the legal battles are still not over. But despite this, Manulife Asuransi Jiwa Dharmala continues to operate profitably and successfully in Indonesia.

Background

Manulife Financial Corporation which was based in Toronto was Canada's largest publicly traded life insurance company and a significant global financial services provider. According to the company's latest *Annual Report*, Manulife Financial had over Canadian $400 billion under management at the end of 2006, almost $65 billion in deposits and premiums, and over $31 billion in capital. Profits for the year were just under $4 billion, a 21% increase from 2005 and the 13th successive year of record profits.[1] Manulife was assigned top credit worthiness scores by Canadian and global rating agencies.

Manulife Financial began as The Manufacturers Life Insurance Company in 1887, with the then Canadian Prime Minister Sir John A. Macdonald as its first president. The global orientation of the company's operations was established early, with the issuance of a policy in Bermuda in 1883, and the beginning of operations in Asia in 1897. As far as present day Indonesia is concerned, the business was written in Sumatra as early as 1903.[2] Despite this

[1] Manulife Financial *2006 Annual Report.* All figures in Canadian dollars.

[2] See http://www.manulife.com/corporate/corporate2.nsf/Public/history.html, consulted 31 January 2008.

long-standing tradition of operations in the Asia-Pacific, Manulife Financial became a major global financial institution only recently, when its acquisition of John Hancock Financial Services Inc. in the United States catapulted the company into the premier league of life insurance firms. This merger made Manulife Financial the second largest life insurer in North America and the fifth largest in the world.

The Manufacturers Life Insurance Company was incorporated as a stock company. As was the case with other major Canadian life insurers, Manulife was converted into a mutual company, owned by its policy holders, beginning in the late 1950s. It operated as such for many years, until it again became a publicly-traded share company in 1999. The other major Canadian mutual life insurance companies (Sun Life, Canada Life, and the Mutual Life Assurance Company of Canada, later known as "Clarica") also demutualized at around the same time.

As noted Manulife had been operating in Asia even before the beginning of the twentieth century, first in China (including Hong Kong, China), followed by the Philippines and Indonesia. Today, the group also has significant operations in Japan, and Viet Nam, both dating from 1999. The Japan operation is a joint venture, while that in Viet Nam is the first 100% foreign owned life insurer in the Socialist Republic of Viet Nam. The company has recently reentered the China market, where the Manufacturers Insurance Company first conducted business in 1897. Manulife-Sincochem Life Insurance Company was granted the first branch joint venture license in 2002.

For its part, the Dharmala Group, Manulife's erstwhile partner in Indonesia, was founded in 1954 by Soehargo Gondokusomo as a trading company, subsequently diversifying into several business lines. Gondokusomo's son, Suyanto Gondokusomo, took the company into financial services and was responsible for the joint venture with Manulife. By the mid-1990s the Dharmala group had become Indonesia's tenth largest private sector group, with about 20,000 employees. But the group was highly leveraged and was therefore adversely affected by the Asian financial crisis of 1997-1998.[3] Significantly, however, unlike some other Indonesian enterprises the Dharmala Group was unable to avoid forced restructuring through the courts.

Manulife JV Operations in Indonesia

As part of an overall strategy to enter into new, high growth-potential markets Manulife formed a joint venture in Indonesia in 1985 known as PT Asuransi Jiwa Dharmala Manulife. The partners were PT Dharmala Sakti Sejahtera, a unit of the Dharmala Group, and the International Finance Corporation, the private sector arm of the World Bank.

For Manulife the initial investment in Indonesia was part of a long-term global growth strategy. For the Dharmala Group the motivation was to support its desire to diversify beyond its business roots as a trading company. Manulife brought its expertise to the Indonesian life insurance market, which was small in 1985 but had high potential. The Dharmala Group brought local knowledge to the partnership, as it was among the leading Indonesian private companies.

The joint venture was successful from the beginning and the business had grown steadily. Manulife's operations in Indonesia are well-established with 2006 total premium income

[3] See David K. Linnan, "A Meditation on Three Mythologies," *S C Journal of International Law and Business* (Volt 1 No 3, Fall 2003), pp 4-5.

exceeding US$ 250 million, and with assets of over US$ 60 billion investments under management.[4] The senior management is split between expatriate and Indonesian executives.

It is significant to note that the Indonesian Manulife joint venture affiliate had operated successfully and profitably, despite a serious challenge from its local partner—the focus of this case—that led to a prolonged and bitter legal dispute at the beginning of the 21st century. The various episodes of that dispute resulted in, among other things, a local Manulife executive being jailed, and the company being petitioned into bankruptcy (despite being profitable) and forced to close temporarily. As the story unfolded over an 18-month period the conflict became progressively nastier. As was typical in such situations, stakeholders understood the dispute from quite different perspectives.

Although the legal disputes have continued, this high drama is now largely in the past. Manulife today is quite bullish about Indonesia. To quote the Manulife website:

> Manulife Financial is the majority stakeholder of PT Asuransi Jiwa Manulife Indonesia, a joint venture that began operating in Indonesia in 1985. Headquartered in Jakarta, Manulife Indonesia operates its business through a network of 112 branches in 33 cities throughout Indonesia. Manulife runs its business with the support of almost 5,000 staff and full-time agents, who serve more than 950,000 customers.
>
> Manulife Indonesia was ranked one of the "excellent life insurance companies" in Indonesia by Info Bank magazine, and it is also the only life insurance company in Indonesia to win the "Corporate Social Responsibility Award 2005" in a service industry category.[5, 6]

Challenging Times 2001-2002

Despite the current successes, Manulife's experience in Indonesia had been anything but smooth sailing, due to differences between the company and its local partner. In mid-2000 the Jakarta Commercial Court, which was created in 1999 specifically to facilitate business restructurings, declared Manulife's minority partner, PT Dharmala Sakti Sejahtera, bankrupt. This was a delayed outcome of the economic downturn, brought about by the slow moving processes of the Indonesian Bank Restructuring Agency (IBRA). Later in the same year Manulife, which had to date held 51% of the shares of the joint venture, bought for US$ 17 million an additional 40% interest in PT Asuransi Jiwa Dharmala Manulife through a public auction process, initiated by the receiver of PT Dharmala Sakti. Manulife was the only bidder for the shares previously held by the affiliate of the Dharmala Group.

The transaction did not close smoothly, however. There was immediately a dispute as to who actually owned the shares, with Roman Gold Holdings Ltd, based in the British Virgin Islands, emerging with a counter claim that they were the legitimate owner of the same

[4] Based on 2006 annual report of PT Asuransi Jiwa Manulife Indonesia, with figures converted at the exchange rate prevailing in March 2008. Manulife Indonesia with figures converted to dollar.

[5] http://www.manulife.com.hk/manulife_public/asia/indonesia.html, 29 August 2007.

[6] Corporate Social Responsibility (CSR) is taken very seriously by Manulife at the corporate level, In Indonesia, CSR is channeled through the Manulife Care Foundation, which was established in 1998. Its major activities are in the education, forestry and health care. For more information see the PT Asuransi Jiwa Manulife Indonesia annual report.

shares and that the Manulife shares were forgeries.[7] There were no records in PT Asuransi Jiwa Dharmala Manulife's share registry of Roman Gold Holdings, nor were there any indications that Suyanto Gondokusumo had assigned these shares.[8] In fact Roman Gold Holdings turned out to be a shell company established by Suyanto Gondokusumo. Its Jakarta office was a noodle vendor's shop in Chinatown

This link was only established after a protracted battle ensued, involving both the civil courts and the criminal justice system in Indonesia, which subsequently ruled in Manulife's favor. But the process was a long and complex one with many twists and turns, fraught with drama, and closely followed by the global business media. Manulife VP Adi Purnomo Wijaya was jailed for allegedly forging share certificates. The money that Manulife paid for the shares was confiscated as evidence. PT Asuransi Jiwa, Manulife Indonesia's president, an expatriate, received threats and his spouse was mugged in a Jakarta suburb, in an incident that might have been connected.

There were very visible interventions by Canadian officials beginning with the Trade Commissioner in Jakarta but ultimately extending to the most senior levels of the Canadian government. The jailed vice-president of PT Asuransi Jiwa Manulife Indonesia was only released following intercession by Canadian Prime Minister Jean Chrétien to Indonesian President Abdurrahman Wahid. There were allegations of corruption involving senior police officers.

PT Asuransi Jiwa Manulife Indonesia brought legal action against the Dharmala Group in Hong Kong, China; and Singapore claiming that Roman Gold Assets Ltd was a front for the Gondokusumo family created for the purpose of holding on to its 40% stake. An important development in this regard was the 18 May 2002 ruling in Singapore that froze the assets of the Gondokusumo family in the island republic. Since wealthy Indonesian business people often kept assets in Singapore, and sometimes resided there, the safety of doing so was called into question.

But that was not the end of the story, as PT Asuransi Jiwa Manulife Indonesia itself was petitioned into bankruptcy by its former shareholder PT Dharmala Sakti Sejahter. In 2002 the Jakarta Commercial Court declared PT Asuransi Jiwa Manulife Indonesia bankrupt because it did not pay a dividend in 1999, and thus had an unpaid debt to Dharmala, which still owned 40% of the company at the time. This ruling was made despite the fact that the shareholders had expressly agreed in 2000 not to pay a dividend. The court took note of the fact that the original terms of the joint venture agreement evidently did contemplate a dividend, should the company generate profits.

The story unfolded as follows: The court had appointed a receiver to the Dharmala Group, who launched a petition claiming that PT Asuransi Jiwa Manulife Indonesia was indebted to the company's estate. As a result the court also appointed a receiver for PT Asuransi Jiwa Manulife Indonesia. Manulife alleged that the actions of the receiver were biased and were intended to force a closure of the company, which was the fourth largest life insurer in Indonesia with over 400,000 policy holders.

PT Asuransi Jiwa Manulife Indonesia did close briefly in mid-2002 due to pressure from the receiver. Following the bankruptcy ruling made on 13 June 2002, the receiver took out full page advertisements in the local business press advising policy holders to submit their claims immediately, and some local hospitals refused to accept PT Asuransi Jiwa Manulife

[7] http://origin.www.cbc.ca/money/story/2001/05/21/manulife010521.html, consulted 1 February 2008.

[8] http://www.Asiaweek_com A Deal Is Not A Deal 16-2-2001.htm, consulted 31 January 2008.

Indonesia health coverage.[9] The receiver also ordered the company to cease operations, despite the fact that the courts had said that normal operations could continue. To assure the safety of its employees, who were threatened with arrest, the company closed its doors, resuming operations on Thursday, 27 June 2002.

The announcement of the shutdown and subsequent re-opening was managed as part of a well-conceived public relations campaign designed to maintain the public's confidence in PT Asuransi Jiwa Manulife Indonesia and to undermine the credibility of the Dharmala Group. The Indonesian Supreme Court overturned the Jakarta Commercial Court's decision to petition PT Asuransi Jiwa Manulife Indonesia into bankruptcy. However the ruling was based on a technicality and did not address the fundamental question of the validity of forcing a profitable going concern into bankruptcy on the basis of the contention that an undeclared dividend could be construed as a debt.

Subsequent discussions with policy holders nonetheless confirmed that because of assurances from the Manulife management, there was no detrimental loss of trust in the company. There was excellent communication throughout between Manulife management and its field insurance agents, and between the field insurance agents and their clients. The openness was reinforced by the well-publicized fact that insurance claims continued to be honored throughout the dispute. For the most part, the Indonesian public relied on their direct communication with company representatives and did not concern themselves with the technicalities of proceedings at the Jakarta Commercial Court, which did not receive as much attention as one might have expected.

As its dispute with the Dharmala Group deepened, Manulife defended its interests vigorously and won both the legal and global public relations battles by being strategic as well as tenacious in its approach. Management designed and professionally executed a strategy that involved using all means of legal recourse available, together with effective public communications and strong advocacy including high level diplomatic intervention. The company by-passed what it saw as a badly-flawed Indonesian legal system by initiating successful legal action in Singapore.

In contrast, the strategy of the Dharmala Group seemed to have evolved from one which was initially focused on preserving the value of its assets, to one aimed at inflicting maximum damage to PT Asuransi Jiwa Manulife Indonesia. Thus matters of "face" might well have played a significant role in determining behavior as the case evolved. In this regard it is significant that in the late 1990s the Dharmala Group found itself being forced to liquidate assets by the courts, whereas other Indonesian financial groups seemed to have been more successful in avoiding such forced restructurings following the Asian financial crisis.

Aftermath

The case was widely viewed internationally as an abuse of litigation, and was something of a black mark on the Indonesian investment climate.[10] The international business press reported the case extensively and concluded that corruption was rampant within the Indonesian court system. This view was reinforced by an admission by the Minister of Justice and Human Rights that the judges who ruled against PT Asuransi Jiwa Manulife Indonesia had been

[9] *Asia Times*, 28 June 2002.

[10] Indeed there is evidence that lack of foreign investment continues to limit Indonesia's efforts at economic recovery.

involved in bribery. Subsequently, the United Nations decided to send a "special rapporteur" to Indonesia to examine the legal system.

In fact the situation in which the case unfolded was highly complex. The International Monetary Fund (IMF) had strongly urged Indonesia to revamp its bankruptcy laws in the aftermath of the Asian financial crisis in order to provide creditors with greater leverage. Indeed the Fund made this reform a key condition of on-going support during the period following the crisis. But the resulting legislation appeared to have given even greater powers to debtors than might reasonably be warranted.[11] In short, Indonesia went almost overnight from a system in which the rights of creditors in business restructurings were very limited to one in which they were considerable, and arguably excessive. At the same time Indonesia was attempting to move from a regime in which disputes were resolved informally, based on established connections, to a rules-based approach.

The Jakarta Commercial Court itself was created with international assistance, in order to correct a serious shortcoming from a lack of effective processes for adjudicating commercial disputes. At the outset in 1999, there were great efforts to ensure the independence of its judiciary, but this might not have worked out in practice. In addition there appeared to be issues of capacity and competence in both the judiciary and the legislative arms of government.

Two points stood out regarding the Indonesian judicial process, according to local observers interviewed in the preparation of this case. Additional capacity building was needed for the Jakarta Commercial Court, as it was unclear whether the fundamental issues of law were well understood by the relevant parties. On the other hand, the Dharmala Group might have understood what was at stake very well, and had been in a position to influence the outcome of the process.

But despite the challenge to its credibility as a result of this case, on balance observers in Indonesia saw the creation of the Jakarta Commercial Court as having strengthened governance. The court had increased the attention given to large companies so that their reorganization did not bring down innocent clients and consumers that had given such businesses their trust. In 2004, for example, a publicly listed property company, PT Bukit Sentul, was brought before the Jakarta Commercial Court for neglecting to fulfill its contract to build houses already paid for by many middle income families. The result of the restructuring process allowed a new investor to come in, take over the management of the business and assume its debt. This allowed the business to continue under a new name (PT Sentul City) and to fulfill its original obligations.

Differing Perspectives

As was inevitable in such cases, stakeholders from the investing and host economies saw the matter quite differently. Canadian stakeholders perceived these events as an attempt by a faction of the Indonesian business community to hang on to its depreciated assets at all costs in the wake of its business failure in the aftermath of the Asian financial crisis. They believed they were dealing with private and public officials whose actions would harm not only PT Asuransi Jiwa Manulife Indonesia, but also Indonesia's reputation among the global business community and ultimately the success of its economic recovery.

[11] Indeed, in another recent case in 2004 the Indonesian subsidiary of the UK-based insurer Prudential was forced into bankruptcy on the basis of a commission claim by a local agent.

As early as 2000, for example, Canadian firms were being advised to exercise caution when buying assets from the IBRA and the Indonesian Ministry of Finance.[12] But by the time the crisis reached its peak the tone had become much tougher, and there was talk of economic retaliation. In between the start and the height of the crisis, Canadian officials, up to and including the Prime Minister himself, were very visible and supportive of Manulife. Their interventions focused not only on the interests of Manulife as a Canadian-based company, and its Indonesian affiliate, but also on the consequences of the actions of the Dharmala Group and the Indonesian legal infrastructure for the economy's investment climate. The Canadians encouraged this theme to be taken up by other developed economies, as well as by the major International Financial Institutions. The International Monetary Fund (IMF), for example, commented on the urgent need for Indonesia to continue to reform its bankruptcy laws and strengthen its legal institutions.

The Indonesian reaction was different, even among government officials who understood that legal and institutional reforms were needed. Manulife and the Canadian government were accused of being high-handed and of interfering in Indonesian affairs. Their criticisms of the lack of transparency and the effectiveness of local processes were deemed inappropriate, as were the tacit threats to undermine Indonesia's efforts to secure foreign capital. At least some observers have pointed out the irony that while the global community was pressing Indonesia to reform its legal processes, in fact there was reluctance by non-Indonesians to allow due process to unfold. Despite the rhetoric in favor of rule by law, there was limited trust in the legal system or the judiciary. Of course the counterview was that the process was seriously flawed and captive of special interests.[13]

Finally, some in the Indonesian private sector questioned the appropriateness of the original choice of the Dharmala Group as Manulife's business partner. The Gondokusumos were viewed as outsiders by some in the Chinese-Indonesian ethnic business community. Moreover, their ethical practices were questioned.[14]

Members of the indigenous business community indicated to the authors that they were well aware of the shortcomings of the legal system in Indonesia. In particular, they believed that the bureaucracy and the courts could not be relied upon fully to uphold the law. In their view the design of the legislation and accompanying regulations were often not the main problem. Rather, the issues stemmed from inconsistencies in the interpretation and implementation of rules by both enforcement officials and the judiciary.

The commonly-held viewpoint was that the problem was an ethical one. This general feeling was not necessarily substantiated by hard evidence related to specific cases (such as the Manulife-Dharmala Group dispute). Nonetheless the viewpoint was widespread and the perceptions were based on what were commonly believed to be prevalent practices.

Observers of the local scene noted that many regulations were actually written based upon good governance practices in western economies, often developed by, or in close consultation with, experts from those economies. But there had been a gap between what had been written and what was practiced.

Unfortunately given local cultural considerations, what was the normal practice was not altogether transparent. Deviations between actual and prescribed conduct could not always be untangled to the extent that allowed truth to be revealed. Because this applied to the

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[12] "Be wary of buying Indonesian Assets," *Straits Times,* 2 December 2000.

[13] See David K. Linnan, "A Meditation on Three Mythologies," *S.C. Journal of International Law and Business* (Volt 1 No 3, Fall 2003).

[14] *Ibid.*

whole system of social and business relationships in Indonesia, it was seen by local observers as one of the fundamental causes of Indonesia's sovereign credit rating remaining at a below-investment grade level since the financial crisis of 1997-1998.

The indigenous business community would like to see a sustained improvement in the investment climate. But such a structural change would bring with it winners and losers. It would be difficult to engineer such a fundamental change in business practice in concert so that every business would benefit equally and at the same time. If practices were to change, the rules of the game would need to shift across the board simultaneously in order to assure benefits for the whole indigenous business community. This would require exceptional leadership both from within the business community and government.

For its part, the Indonesian government also would like to see the economy's investment climate improve. But there were quite mixed opinions and feelings on the part of individual officials familiar with the Manulife case regarding what specifically would need to be altered. For example, the consistent enforcement of rules and regulations aligned with global good practice was seen as key. But some officials noted that global investors with the sophisticated lawyers and deep pockets (such as Manulife) always seemed to manage to come out on top. This in their view might be a 'fair' game in terms of a strict application of the law, but given that the players did not have the same level of sophistication, in practice the playing field was *not* level. It should be noted that the same type of criticism was sometimes leveled at the litigation process in advanced economies too.

Officials who were involved "hands on" with the Manulife case were also far from agreeing as to what should have been done to manage the process in the interests of the host economy. Senior, mid-level and working-level officials lacked unified perspectives (both legal and ethical) on how to choose the most appropriate course of action. This difficulty in finding consensus was common in the Indonesian milieu at that time, and the barriers to reaching agreement represented a structural weakness in the decision making system, which increased the systemic risk of doing business in the economy.

More recently, however, and especially under the current Indonesian government, change was in the air. It was apparent that the highest level of government was working seriously on improving the investment climate. This was having a direct impact on the ministries responsible for dealing with foreign investment matters. For example, in the Ministry of Finance, which was closely involved with the Manulife case, one measure taken was to rotate officials in the first and second echelons. New high-level appointees had been given change mandates focused on improving the reliability and transparency of public services. This was widely seen as a positive sign by observers of the local scene.

Lessons for Policy Makers and the APEC Process

This case offers many lessons for foreign investors, for host economy partners, for governments and for inter-governmental dialogue.

First and foremost, business disputes are inherently difficult to resolve, especially when they involve participants from differing economies operating under divergent cultural assumptions and legal traditions. These disparities in knowledge, approach and perception do not detract from the reality that there were, in this particular example, vastly different interests at play. The case does, however, illustrate how quickly disputes can escalate when trust and understanding are missing.

Second, the case strongly supports the benefits of developing effective, transparent, rules-based frameworks for resolving commercial disputes. But such systems do not operate in a vacuum, and there can often be unintended consequences, particularly during times of rapid structural economic and administrative changes. In the final analysis good commercial dispute resolution needs to balance formal and informal processes in a manner that is acceptable to both parties.

Third, investing companies need to have a good understanding of the systemic problems in the host economy and a realistic expectation of what to expect. For example companies investing in Indonesia need to appreciate the lack of transparency, and weak regulatory enforcement that they will encounter, and come in with a game plan that increases the chances of success.

Fourth, capacity building and bridging the culture gap should be in the minds of main stakeholders. In writing rules and regulations conforming to international standards, a national multi-stakeholder consultation process could, to a certain degree, better bridge the gap between what is expected internationally and what is prevalent locally. And further, developing a capacity building program that not only involves classroom training but in-situ or on the job monitoring and feedback, done in a respectful manner could also be of much help.

Fifth, public scrutiny is a powerful force for change. In Indonesia, as elsewhere in the Asia-Pacific region, there is a genuine desire to ensure that better governance is put in place. Change agents at the right levels within government can supplement the pressure imposed by non-government stakeholders (both global and local), as the Manulife case shows. Government will be reticent to find themselves in the spotlight by being involved in a similar dispute in the future.

Finally, the case illustrates the payoff of professional crisis management. While Manulife's behavior was perceived as high-handed by some in Indonesia, equally the behavior of the Dharmala Group was seen as reprehensible in Canada and other developed economies. Setting emotion aside, the fact was that the Manulife's strategic approach to crisis management ultimately preserved the reputation of PT Asuransi Jiwa Manulife Indonesia, paving the way for the company to resume operations.

Concluding Thoughts

Despite the intensity and the bitterness of the dispute in a real sense the case has had a happy ending, as Manulife continues to operate profitably in Indonesia to this day. The battles have not ended yet, however, with the Dharmala Group having (possibly) launched further legal actions. Stay tuned!

Freeport's Grasberg/Ertsberg Mine in West Papua, Indonesia

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This case was developed using information available in the public domain, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

Freeport-McMoRan Copper & Gold, Inc. (Freeport) has been investing in the exploration and exploitation of copper, gold and silver in the Grasberg/Ertsberg mine in West Papua, Indonesia since 1967. While Freeport's investment had been both fairly profitable and contributing to the economy of Indonesia, it has caused serious security and environmental problems. Also, Freeport's payment to Indonesian military and police officials was criticized as bribery and causing human rights violations.

In order to fend off these criticisms, Freeport has been investing in security and environmental protection as well as in local community development. Such investment has been fairly effective in improving the security and environmental conditions of the mine and the social conditions of the local community. However, as shown in recent reports by the mass media and a few NGOs, there is still room for improvement in security, environmental protection and community development initiatives by Freeport.

Freeport defended its payment to Indonesian military and police officials as necessary to maintain the security of mine workers and the mine region. However, such argument was not enough to fend off the criticism that direct payment to military and police officials is prohibited under both Indonesian and US laws.

Currently, the US Securities Exchange Commission (SEC) and the US Justice Department are investigating Freeport's payment to Indonesian military and police officials. Freeport, as a successful investor in natural resources development in developing economies, should make utmost effort to tackle social problems such as environmental protection and local community development. It should also make its business and accounting more transparent.

The case of Freeport provides an illustrative example of the changing environment and challenges that a long-term foreign investment faces.

Introduction

Profile of Freeport-McMoRan Copper & Gold, Inc.

Freeport-McMoRan Copper & Gold, Inc. (Freeport) was the world's lowest-cost copper producer and one of the world's largest producers of gold. It was formerly based in New Orleans, Louisiana but recently moved its headquarters to Phoenix, Arizona, after acquiring copper producer Phelps Dodge Corp. in 2007. It had been investing in the exploration and exploitation of copper, gold and silver in the Grasberg/Ertsberg mine in Papua province, Indonesia (formerly Irian Jaya or West Papua), the world's largest gold mine and the second largest copper mine deposit,[1] since 1967.

The Business Rationale for the Investment

The 2005 year-end aggregate proven and probable recoverable reserves of Grasberg/Ertsberg mine deposit totaled 2.8 billion metric tons of ore, whose grade was 1.07% copper, 0.92g/t gold and 4.02g/t of silver representing 56.6 billion pounds of copper, 58.0 million ounces of gold and 180.8 million ounces of silver.[2]

Overview of the Investment Experience

In 1936, Jean Jacques Dozy, a Dutch mining engineer, discovered the Ertsberg mineral deposit, but the report on the find had gone unnoticed due to World War II. Freeport discovered the report in 1960 and that same year, the expedition led by Forbes Wilson and Del Flint rediscovered the Ertsberg mineral deposit.

Freeport signed a Contract of Work with the government of Indonesia on 7 April 1967, making Freeport the exclusive mining contractor for the Ertsberg deposit and all the other mining deposits within a 10 km radius. According to the Contract, the 30-year contract term would begin as soon as the project was declared operational. On 1 July 1973, after the successful exploration drilling and completion of the feasibility study, Ertsberg was declared operational, and the 30-year contract term started.

By the mid-1980s, the mine had been largely depleted. However, Freeport, instead of selling it, searched for further deposits in the area. In 1988, the Grasberg copper/gold deposit was discovered just three kilometers from the Ertsberg mine. A series of expansions were initiated following the discovery, which resulted in a fairly promising discovery of copper and gold deposits.

In June 1991, Freeport signed with the Indonesian Ministry of Mines a new Contract of Work with a 30-year term and provisions for two 10-year extensions to 2041. The contract allowed Freeport to conduct exploration, mining and production activities on a 24,700-acre area (Block A). Freeport could also conduct exploration activities in approximately 500,000 acres (Block B). All of the proven and probable mineral reserves and current mining operations were located in Block A. Freeport also had exploration rights covering 1.7 million acres in addition to Blocks A and B.

Freeport owned 90.64% of PT Freeport Indonesia, the principal operating subsidiary in Indonesia, including 9.36% owned through its wholly owned subsidiary, PT Indocopper Investama. The Government of Indonesia owned the remaining 9.36% of PT Freeport Indonesia. In 1995, PT Freeport Indonesia announced a US$ 1.35 billion strategic alliance with Rio Tinto-Zinc Corporation, a UK-based mining company. Freeport later purchased 23.9 million common shares from Rio Tinto for US$ 882 million in 2004, though the Freeport-Rio Tinto Grasberg joint venture continued.

In 1998, the Gresik copper smelter and refinery was completed. The entire smelter feedstock was transported by ship from Freeport's Grasberg mine, some 2,600 kilometers to the east. Gresik, located 30 kilometers north of the city of Surabaya, East Java's major port, was the first copper smelter in Indonesia. Gresik's equity partners were Mitsubishi Materials with 60.5%, PT Freeport Indonesia with 25%, Mitsubishi Corporation with 9.5%, and Nippon Mining and Metals Co. Ltd with 5.0%.

In 2005, Freeport achieved record copper and gold production of 766,000 tons of copper and 107 tons of gold. In 2007, with the acquisition of Phelps Dodge, a New York City-based mineral company, Freeport became the world's largest copper company with mining deposits in Indonesia, Europe, North America and South America.[3]

Ore from the open pit and from underground block-caving operations was transported by conveyor through adits to centralized mine facilities. Mine facilities included a power plant, several mills, crushing and screening operations, concentrators, thickeners and a pump station. Three pipelines delivered concentrate (slurry) composed of 65% solids-by-weight from the mill to the port site at Amamapare 74 miles away. In addition to these mining facilities, Freeport constructed an airport, a port, a 119 km road, an aerial tramway, a hospital and related medical facilities, two town sites with housing, schools, and other facilities

sufficient to support more than 17,000 persons, consisting mainly of mine workers and their families.[4]

Challenges Faced in Implementing the Investment Decision

Deadly Landslides

The mine was located in the steep mountainous area reaching as high as 4,500 meters above sea level. The steepening of slopes resulting from mining activities, as well as earthquakes and frequent heavy rainfall, had resulted in deadly landslides in the mine workings and overburden[5] stockpiles in 2000, 2003 and 2006 with more than a couple of dozen casualties.

Waste Management

Since 1997, the Indonesian Environment Ministry had repeatedly warned Freeport that the company was breaching environmental laws, stemming from operations that had already generated an estimated six billion tons of waste. Much of the waste had been dumped in the mountains surrounding the mine or down a system of rivers that descended steeply onto the island's low-lying wetlands, close to Lorentz National Park, a pristine rain forest reservation that was declared a World Heritage site in 1999 by the UNESCO.

The mine dumped 110,000 tons of tailings per day into the Ajikwa river, and by the time it closes in 30 years, it will have excavated a 230 square-kilometer hole in the forest that will be visible from outer space.[6] The danger was that the waste rock atop the mountain would trickle out acids into the honeycomb of caverns and caves beneath the mine in a wet climate with 12 feet of rain a year. Freeport could curb much of it by blending in the mountain's abundant limestone with the potentially acid producing rock. But before 2004, a report by Parametrix, a consulting company who did the study for Freeport, said that the mine had an excess of acid-generating material. There were signs that acids were already flowing into the groundwater, according to a geologist who worked at the mine.[7]

The amount of sediment resulting from dumping wastes presented another problem. Too many suspended solids in water could smother aquatic life. Indonesian law stated that these should not exceed 400 milligrams per liter. According to an environment ministry's field report in 2004, Freeport's waste contained 37,500 milligrams as the river entered the lowlands, and 7,500 milligrams as the river entered the Arafura Sea.[8]

In October 1995, the Overseas Private Investment Corporation (OPIC), a United States government agency that insured American corporations for political risk abroad, revoked Freeport's insurance policy for environmental reasons. In doing so, two environmental experts, Harvey Himberg (an official at the agency) and David Nelson (a consultant), issued a report after visiting the mine for several days. The report was critical of Freeport's operations, especially the huge amounts of waste it had dumped into rivers. Freeport refuted the report, arguing that it reached inaccurate conclusions. Freeport said that it had considered a full range of alternatives for managing and disposing of its waste instead of using the river, and settled on the best one. Freeport threatened to take the agency to court over the cancellation of its insurance. After protracted negotiations, the insurance policy was reinstated for a few months, as a face-saving gesture to Freeport. It was not renewed.[9]

Freeport suspended all exploration activities outside of Grasberg Block A in December 2006 because of safety and security issues and regulatory uncertainty relating to a possible conflict between mining and exploration rights in certain forest areas and an Indonesian Forestry law enacted in 1999 prohibiting open-pit mining in forest reservation areas. Recent Indonesian legislation permitted open-pit mining in Freeport's Grasberg Block B area, subject to certain safety and reservation requirements. Following an assessment of these requirements and a review of security issues, Freeport planned to resume exploration activities in certain prospective Contract of Work areas outside of Block A.[10]

Payments to Local Military and Police Officers

In the Grasberg/Ertsberg mine area, human rights investigators had documented numerous human rights violations, including rape, torture, extrajudicial killings and arbitrary detention committed by the Indonesian military against indigenous communities living near the mine. For instance, according to the Australian Council on Overseas Aid, during 1994 and 1995, the Indonesian military, with the assistance of the mine's own security forces, caused the "disappearance" or death of 22 civilians and 15 other people who were alleged to be "guerrillas."[11] Human rights advocates had long suspected that Freeport was paying Indonesian military, an arrangement that would make the company complicit in the military's abuses... and that was the case.

In 2003, after being forced to disclose information by the US Security Exchange Commission (SEC), Freeport admitted that it had been paying the local Indonesian military and police officers to keep the native landowners away from the lands it developed under the existing contract. It argued that this was necessary to provide security to its employees.

In 2005, the New York Times reported that the total amount paid between 1998 and 2004 amounted to US$ 20 million.[12] The New York City comptroller charged Freeport of having knowingly made false or misleading explanations about payments to the Indonesian military in violation of the Securities Exchange Act as well as Foreign Corrupt Practices Act, which forbid American companies from paying bribes to foreign officials. The SEC and the US Justice Department were investigating these claims.[13]

Relationship with Local Communities

In March 1996, the long-simmering anger at the company erupted in rioting when anti-mining sentiment among different groups coalesced into what was perhaps the biggest threat to Freeport to this day. The mine and its mill were shut down for three days. Rioters destroyed US$ 3.0 million worth of equipment and ransacked offices. Freeport intercepted e-mail messages which suggested that certain military units, the community and environmental groups were working together. Local leaders later met with company officials and said that they had provoked the disturbances as a means of expressing their aspiration to receive greater benefits from Freeport's operations.[14]

In February 2006, Freeport prohibited indigenous people from collecting gold out of the tailings of Grasberg mine. Protestors blockaded the road to the mine and clashed with the local police. Freeport suspended its operations. After Freeport accepted the requested increase in the indigenous people's share of the Community Development Program, the protestors lifted the blockade and Freeport resumed its operations.[15]

Labor Dispute

In April 2007, operations at Grasberg mine were halted as thousands of workers attended a rally over a labor dispute. The police said 2,500 protesters turned out in Timika, about 62 miles from the Grasberg mine, demanding that their salaries be raised to 3.6 million rupiah, or US$ 395 per month from 1.45 million rupiah.[16]

Approaches Taken by Freeport to Address Challenges

On Landslides

Freeport suspended its operations after the landslide incidents, and resumed operations after it had brought the sites back into good condition. Before resumption of operations, the Indonesian mining authorities inspected the sites and authorized the resumption. Freeport had also been reclaiming and replanting the area.

According to Freeport, its safety performance continued to compare quite favorably with that of similar US mining companies. A statistical comparison showed that Freeport's 2001 lost-time-injury rate per 200,000 hours worked stood at 0.36, well below the US metal/non-metal mining industry average rate of 2.24. Further, Freeport's total reportable rate (all reportable injuries) of 0.83 was significantly lower than the US industry average rate of 4.04. Within the five-year period starting in 1996, PT Freeport Indonesia's safety performance in 2001 was second best only to their 1999 record. For these efforts, Freeport received the Golden Award from the Indonesian Department of Energy and Mineral Resources, which recognized both safety performance and safety management system implementation.[17]

During 2006, the lost-time-injury rate per 200,000 working hours at PT Freeport Indonesia was 0.10, an improvement over 2005 and comparing very favorably with the US metals and mining industry average for 2005 of 2.15. The total reportable injury rate per 200,000 working hours was 0.31, an 18% improvement over 2005 and again comparing favorably with the 2005 industry average of 3.55.[18]

Freeport was implementing its safety policy through the Freeport Safety and Health Management System, which was also adopted by all contractors and privatized companies serving its operations in the Grasberg mine. It involved management and supervisory focus: a comprehensive safety management system for every aspect of operations; introductory, fundamental, specific skill and supervisory training (including annual refresher courses); and a system to track results and progress in achieving safety goals.

Freeport measured its progress using the international NOSA (National Occupational Safety Association) 5 Star Rating System, as well as the Supervisory Safety Accountability Program to measure supervisory safety performance. Annual safety and industrial health performance was a key indicator in the annual performance review of each supervisor and manager. The system had worked well and Freeport's safety performance had consistently compared very favorably with that of mining operations in the US and other economies. In 2006, 15 Freeport divisions achieved 5-star ratings from NOSA. In addition, several divisions were recognized as best-in-class worldwide when compared with other operations using the NOSA system.[19]

Freeport's Corporate Safety and Health Policy Statement, adopted by its Board of Directors on 31 July 2007, declared that "[t]he safety and health of all Freeport …employees …are of the highest priority", and that their "objective is zero work place injuries and occupational illness."[20]

On Waste Management

Freeport had long complained about problems of conflicting Indonesian environmental legislation. Forestry law 41 of 1999 essentially prohibited exploration and exploitation of natural resources existing within a protected forest. If interpreted literally, the law would prohibit operations even if the protected status was conferred subsequent to the issuance of a Contract of Work. Hazardous waste regulation issued in 1999 (PP18/1999) revised toxicity characteristics leaching procedures (TCLP) numbers for waste disposal, which far exceeded standards in Australia; Canada; and the US.[21]

On the other hand, Freeport claimed that it had a comprehensive waste management system involving waste reduction and segregation of hazardous wastes in compliance with relevant Indonesian regulation. Its 2006 *Working Toward Sustainable Development (WTSD) Report* explained its activities in detail as follows:

1. Freeport had been conducting annual internal environmental audit since 1994.
2. It was awarded ISO 14001 certification in December 2001.
3. It participated in the environmental management performance rating program, known as PROPER, which was administered by the Indonesian Ministry of Environment. The rating evaluation was mainly based on the performance of companies in managing effluent discharges, air emissions and hazardous wastes.
4. Its environmental management system included an in-house environmental inspection program that is conducted continually throughout the year.
5. In 2005, its triennial independent external environmental audit was conducted by Montgomery Watson Harza to fulfill one of Freeport's commitments that was included in its Environmental Impact Assessment (AMDAL) approved by the Government of Indonesia in 1997.

The audit concluded that Freeport's mining operations "are among the largest and most environmentally challenging and complex in the world" and that the company's "environmental management practices continue to be based on (and in some cases represent) best management practices for the international copper and gold mining industry."[22]

The tailings deposition system was operated under Freeport's tailings management plan, which was approved by the Government of Indonesia during the 1997 300K AMDAL (environmental and social impact study) process. As part of the 1997 AMDAL process, it was agreed that the approved tailings management option should be studied further. A Tailings Review Committee comprising of members of the Environmental Risk Assessment Review Panel Team, Freeport Environmental Advisory Council and Freeport management was established to review this issue. After the completion of a series of detailed studies, including an analysis of remote sensing information, evaluation of potential pipeline options, a review of geotechnical considerations, flood and hydro-geological impacts and comprehensive risk assessments, the Committee concluded that the approved tailings management system was the best option available.[23]

A technical group comprising of experts and representatives of the Bandung Institute of Technology, PT Puri and Freeport reviewed the Freeport's tailings management practice and developed some recommendations to enhance the effectiveness of tailings retention program techniques. The tailings retention plan divided the deposition area into three sections based on the elevation, sediment grain size, and type of flow, and details specific techniques that may be effective in each section. The recommended techniques included the use of bio-filters, permeable groins, flow deflection structures and other engineering applications.

Freeport was committed to the implementation of the plan. In 2002, Freeport also submitted to the Government of Indonesia a detailed Environmental Risk Assessment (ERA) of the tailings management system. It found the identified environmental impacts of Freeport's tailings management system consistent with those anticipated by the AMDAL of 1997. Freeport started a five-year update of the ERA study which should be completed by 2007.[24]

Studies of tailings reclamation and the establishment of demonstration plots on deposited tailings showed that tailings could be readily replanted with native forestry and agricultural plants. In fact, natural re-colonization had rapidly taken place. Upon the completion of mining, the tailings deposition area would be reclaimed in a manner consistent with the appropriate technique established through consultation with various stakeholders, taking into account appropriate consideration of environmental and social impacts.[25]

Freeport also claimed that it had not caused serious degradation of the water quality of rivers. Again, according to its 2006 WTSD Report, extensive sampling of water quality in the tailings management system showed that the water in the river that transported the tailings from Freeport's mill in the highlands to the lowlands tailings deposition area met the Indonesian and the US Environmental Protection Agency (EPA) drinking water standards for dissolved metals. Data from biological sampling continued to demonstrate that the estuary downstream of the tailings deposition area was a functioning ecosystem, based both on the number of species and the number of specimens collected of nektonic, or free-swimming organisms such as fish and shrimp.[26]

With the approval of the Government of Indonesia, Freeport constructed a new levee to the east of the existing west levee. This created a new channel between the new levee and the old west levee, and Ajkwa River was diverted to the new river in 2005. The diversion of Ajkwa River from the tailings deposition area to its original channel had a number of environmental advantages. It significantly decreased the amount of tailings transported through Ajkwa River to the tailings deposition area. It provided additional natural fresh water flow along the eastern boundary of the heavily populated area of Timika. It also allowed large-scale reclamation demonstration projects to be carried out on previously deposited tailings in the area between the two western levees. This area had become the site of successful reforestation and agriculture projects.[27]

To address the acid rock drainage (ARD) problem caused by sulphide minerals contained in overburden (see *supra* n.5), Freeport had been implementing a comprehensive Overburden Management Plan approved by the Government of Indonesia. Under the Plan, Freeport placed overburden in managed areas around the Grasberg open pit, and provided for capture and treatment of the existing acid rock drainage, in conjunction with limestone blending and limestone capping of existing overburden placement areas to manage future acid rock drainage generation.[28]

On Payments to Local Military and Police Officers

Inasmuch as the investigations by the US SEC and Justice Department were ongoing, Freeport had declined any official comments on the details of its payments to Indonesian local military and police officials.

On the other hand, Freeport's Social, Employment and Human Rights Policy of 2004 declared that in order to uphold human rights standards, Freeport's security personnel would, among others, (1) Respect all people's human rights throughout their daily activities; (2) Consult regularly with local communities on security matters; and (3) Ensure that all security procedures and policies are publicly available in order to mitigate distrust between operations and local communities.

With respect to the security forces not under Freeport's direct control (military and police personnel), the Policy declared that Freeport would (1) Consult regularly on security, human rights, and related work-place safety issues; (2) Communicate company policies regarding ethical conduct and human rights; (3) Support government efforts to provide human rights training and education for all; (4) Inform the public of any arrangements of support made by Freeport for the benefit of public security so that such support shall be transparent and publicly disclosed; (5) Monitor the use of equipment provided by Freeport and investigate situations in which equipment is used in an inappropriate manner; and (6) Report any credible allegations of human rights abuses by public security in the Contract area to the senior military or police official in the area and to the Corporate Human Rights Compliance Officer.[29]

On Community Development

Freeport emphasized its commitment to the local community in its Social, Employment and Human Rights Policy. In order to enhance its commitment, the Policy declared that Freeport would: (1) Build relationships with people in Indonesia and especially with people indigenous to areas of operations or exploration; (2) Work continuously to understand the culture and social patterns of the people in Indonesia and especially the people indigenous to areas of operations or exploration. To accomplish this, Freeport would undertake social, cultural and health studies; (3) Consult with local populations about important operational issues that would impact on their communities; (4) Work with the Government of Indonesia, the local people and responsible non-governmental organizations to create and periodically update social integration and/or sustainable development plans for all operational sites. These plans would address the issue of economic and social viability of each operating area after cessation of operations; (5) Encourage awareness among the employees of attitudes, beliefs and values of the local community; and (6) Recognize its significant impact on the local indigenous population and voluntarily recognize this in various ways.[30]

In furtherance of its commitment to community development, Freeport had established voluntary trust funds for the local indigenous tribes (Amungme and Kamoro tribes) and had contributed US$ 8.5 million through 2006. In conformance with the applicable land rights agreement, it would continue to contribute US$ 1 million annually to the fund. A portion of these funds were used to purchase shares in Freeport, thereby permitting the indigenous people to become equity participants in the mine.

As of 31 December 2006, the funds held a combined total of nearly 22,000 common shares in Freeport, worth more than US$ 1.2 million. These funds were in addition to the Freeport Partnership Fund for Community Development, which had received approximately US$ 242 million from Freeport since 1996 for investments in numerous community development

projects. Examples included the hospitals in Timika and Banti that treated thousands of patients each year; the education program, which provided scholarships or educational assistance to thousands of Papuan students; and economic and village development programs that provided rural income generating projects, clean water, church facilities and other infrastructure to remote villages in the highlands of Papua.[31]

In 2000, after five years of negotiation, Freeport concluded a Memorandum of Understanding (MOU) with Amungme and Kamoro local community organizations, focusing on socio-economic resources, human rights and environmental issues. As part of the 2000 MOU, the MOU Forum was created, consisting of representatives of LEMASA, the Amungme tribal agency; LEMASKO, the Kamoro tribal agency; YAHAMAK, a nonprofit advocacy group for Papuan women and children; the regional government and Freeport. The MOU Forum met regularly to discuss issues related to the implementation of the 2000 MOU.[32]

In 1996, Freeport committed to improve significantly the training and education program for indigenous employees. It pledged to double the number of indigenous Papuan employers throughout the workforce by 2001 and to double that number again by 2006. It also pledged to at least double the total number of Papuan management professional employees. Both goals were met in 2006. At the end of 2006, Freeport had nearly 2,650 Papuan employees, including about 320 Papuan management staff employees, compared to 600 Papuan employees in 1996, of which fewer than 50 were management staff. Another 1,050 Papuans were employed by privatized companies serving Freeport compared to year-end 2005. These numbers reflected a substantial increase in the number of Papuans employed directly and indirectly by Freeport since the end of 2005.[33]

In 2003, Freeport formed the Nemangkaw Mining Institute, whose goal was to provide pre-apprentice, apprenticeship and advanced career development opportunities for Papuans. In 2006, the Institute accepted over 1,000 enrollment in the apprentice and pre-apprentice programs. It was expected that most of these students would be hired by Freeport and its associated partners.[34]

Freeport justified the prohibition of gold extraction from the tailings in February 2006, by pointing out that such extraction was not licensed by the Government of Indonesia and that the panners had moved into the area by the thousands, straining resources (particularly medical resources) and pressuring the local population.[35]

On Labor Issues

The Freeport's Social, Employment and Human Rights Policy of 2004, paragraph 2, set out basic policies on industrial relations. It declared that Freeport was committed to support fundamental principles of labor relations, including the elimination of discrimination in the workplace, the freedom of association and the right to collective bargaining, the elimination of forced and compulsory labor and the abolition of child labor. According to the Policy, in order to support these principles, Freeport would, among others, (1) Obey the laws and regulations of Indonesia with respect to employment practices; (2) Adhere to applicable international standards of health and safety; (3) Employ as many citizen of Indonesia as practicable and, wherever practicable, employ people who are indigenous to the operational and exploration site; (4) Provide training to citizens of Indonesia with a primary focus on those indigenous to the operational or exploration area to prepare them for employment in the operation; (5) Ensure that employees are fairly remunerated; (6) Respect the employee's right to join a union or other coordinated association.[36]

Although the details of the solution of the labor dispute of April 2007 had not been reported, it would be safe to assume that the dispute was settled through peaceful means according to Freeport's policies on industrial relations.

Conclusions

Lessons Learned for the Company, Local/Central Governments, Private Sectors, and Society

Mining is an activity that directly affects natural and human environment over a long period of its operation. It also has serious social impact on the local community where it is conducted. Securing workers' safety and environmental protection must be the top priorities for sustainable mining investment. Freeport must make utmost efforts for achieving them. To this end, it must consult with the Government of Indonesia (Ministries of Mining and Environment, etc.) on how to comply with relevant laws and regulations of Indonesia, including those on environmental protection, workers' safety, labor relations, and protection of land rights of indigenous people.

The host government has a primary responsibility to secure Freeport's compliance with local laws and regulations. At the same time, it must avoid applying conflicting laws and regulations to particular environmental laws. This does not mean that the Government of Indonesia must not enact strict environmental laws and regulations during the long Contract period. It means that such enactment should be conducted through due process, and should be applied in a transparent manner. Such procedure should include prior announcement of a new enactment, consultation with Freeport on what impacts it will bring to the existing Contract, and the renegotiation of the Contract, if necessary.

Merely complying with local laws is not enough. Considering the huge impact of its activities on the natural and social environment of the region, Freeport must take proactive steps to secure the safety and environmental soundness of its activities and to enhance community development. The various measures taken by Freeport particularly since the late 1990s, as discussed previously, show that Freeport has been trying to fulfill its responsibility in this regard. Also, it must be admitted that Freeport has been trying to make its activities more transparent than before, by publishing its annual report on sustainable development since 2001. These efforts, especially the latter, are effective in providing information about Freeport's activities and policies to the stakeholders including the local community, local and central host governments, nonprofit organizations and the company's shareholders. As more and more emphasis are put on corporate social responsibility (CSR) and investors relations (IR), Freeport's effort in that respect serves as a good reference.

Corruption is no longer part of normal business practices for foreign investors. Freeport must assure everyone that it will never make corrupt payments to Indonesian military and police officers, and that it will disclose all financial records to its shareholders. The investors' home government also has a shared responsibility for the elimination of corruption abroad. Investigations by the US SEC and Justice Department will elucidate whether and to what extent Freeport's payment was in violation of the US Securities Exchange Act and Foreign Corrupt Practices Act. On the other hand, Indonesian military and police were not innocent, either. The local and central government of Indonesia should have secured sufficient budget for the maintenance of security in the region. Both investors and host governments are responsible for the elimination of corruption.

Consideration of the Possible Application to Other Economies

Foreign investors in the mining sector in developing economies generally have similar challenges (workplace safety, environmental degradation, corruption, labor dispute, etc.). This case can be applied to investment cases in the mining sector elsewhere. Also, many of the lessons of the case can be applied to long-term investment cases in various other sectors elsewhere. These include the importance of continuous consultative relationship between foreign investors and host governments, the importance of compliance with local laws and regulations, the increasing emphasis on CSR and IR, and the shared responsibility of investors, home governments and host governments in abolishing corruption.

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[3] Freeport-McMoran Copper & Gold, Inc., Company History. http://www.fcx.com/about/history.htm

[4] Info-Mine, *supra* n. 2.

[5] "Overburden" refers to the soil and rock removed from the surface during an open-pit mining operation.

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Revitalizing the Regional Economy: Hokkaido Tracks' Investment in Tourism

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Executive Summary

Even in developed economies such as Japan, foreign investors and entrepreneurs encounter various problems and challenges in the course of establishing their business, especially when these investments take place in local regions without major previous exposure to foreign investment. This case illustrates such challenges through the experiences of Hokkaido Tracks, an Australian developer and property management firm, which invested in the tourism sector of a local ski resort town in Japan.

After the collapse of the bubble economy, the number of Japanese tourists coming to this town dwindled. At the same time many Australians who used to go skiing in North America and Europe started to look for safer ski resorts after the events of September 11. Sensing a business opportunity, Hokkaido Tracks decided to invest in the local ski resort town and became active in the development and management of condominiums. However, their experience had not been a smooth ride as the business model was still new to Japan. The case describes some of the obstacles the Australian firm faced such as the ambiguity of Japanese laws and regulations, the difficulty in obtaining local funding, attracting foreign and Japanese staff, and relating with the local community, among others.

The case also provides local governments some insights on the strategic utilization of foreign investment including comprehensive planning for sustainable development of both local community and foreign firms.

Introduction

In 2006, the highest price hike for residential land in Japan—a steep 33.3%[1]—was recorded not in the three major Japanese cities of Tokyo, Osaka and Nagoya but in a little town in Hokkaido called Kutchan (Figure 1). How could a rural town of less than 16,000 people top the national list?

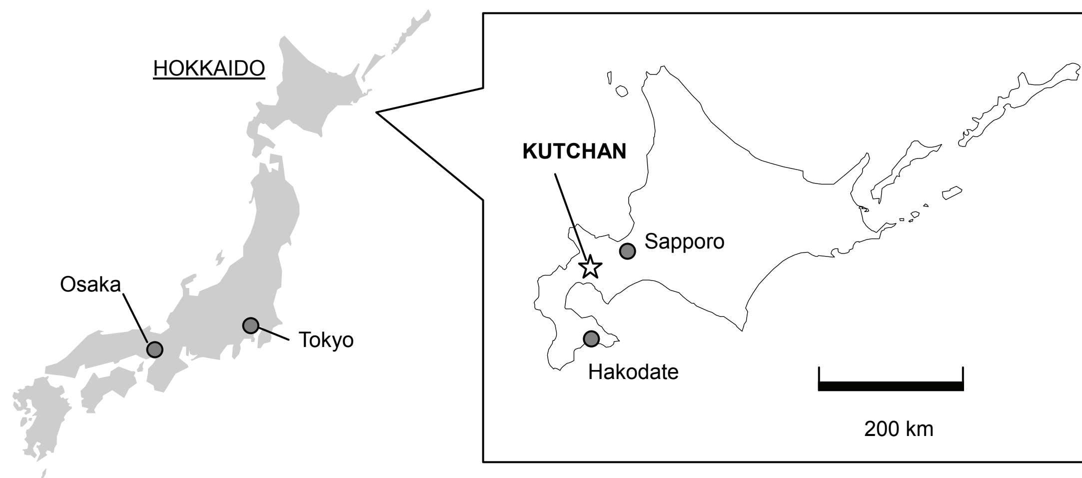
The driving force behind the Kutchan boom was a group of Australians who were quick to spot the potential for development of the area as an international resort. Taking advantage of tourist concerns over safety following September 11, a group of Australian entrepreneurs selected Kutchan as the ideal spot to build an international resort.

With Japan still struggling with the so-called "lost decade" that followed the collapse of the 1980s bubble economy, the entrepreneurs found out that investing in Kutchan was far from being a smooth ride and required them to resolve a succession of problems. At the same time, in absorbing this foreign investment, the local administration and the local community in Kutchan had to rise to challenges well beyond their previous experience in building a relationship with foreign investors.

Kutchan's Development as a Ski Resort

Kutchan was a comparatively new town. The full-scale settlement launched under the direction of the Meiji administration in the 1890s marked the town's beginning. Traditionally strong in agriculture, the area was known for its fine Danshaku potatoes. Mountains and forests covered 51% of the land, while 18% was used for agricultural purposes. There was a marked graying of society in Kutchan, with around 20% of the local population aged 65 years or above.

Figure 1 Location of Kutchan



Kutchan had long been renowned for skiing mainly because of the quality and depth of its marvelous powder snow. The area's selection as the site for the National Ski Championship Tournament in 1962 and the 25th National Ski Meet in 1970 secured its status as a national ski field. Together with the neighboring town of Niseko, the ski fields and foothill areas known collectively as "Niseko" had been long-standing favorites with Japanese skiers.

Back when Japan's period of strong economic growth began, the "Niseko" area rode the economic boom to absorb dynamic investment in the local tourism industry. Three ski resorts were opened in quick succession between the late 1960s and the early 1980s: the Niseko Kokusai Hirafu Ski Resort (now the Niseko Mt Resort Grand Hirafu), the Niseko Annupuri International Ski Ground and the Niseko Higashiyama Ski Ground. At the end of the 1980s and in the midst of the bubble conditions, the release of the film "Take Me Out to the Snowland" spurred an unprecedented ski boom that also took the "Niseko" ski industry to new heights.

Hotels, privately-run pensions, traditional Japanese inns ('*ryokan*') and various other forms of accommodation sprouted around the ski fields. Just as in many other local tourist areas around Japan, these for the most part offered traditional facilities and services targeting Japanese tourists on short-stay package tours. Most rooms were Japanese-style, with futons laid out on tatami matting, and guests were expected to bathe in communal facilities with men in one room and women in the other. Little effort was made to cater to foreign tourists, particularly Westerners.

Tourism Recession and Government Efforts to Bolster the Tourism Industry

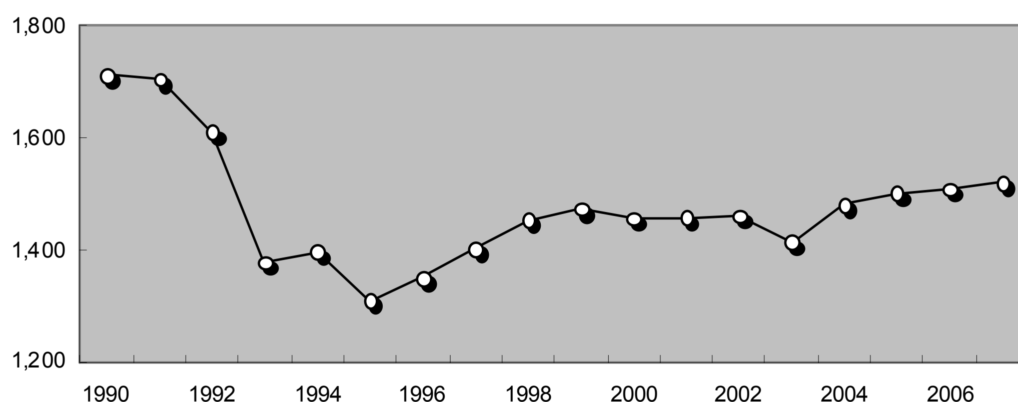
In the 1990s, following the collapse of the bubble economy, circumstances deteriorated. Starting in 1991, the number of skiers visiting Hokkaido had declined, while fewer and fewer visitors were seen in Kutchan (Figure 2). Falling tourist numbers reduced revenues, making it difficult to find the funds for new investment. This in turn pushed tourists further away, creating a vicious cycle. In addition, the ongoing national recession gradually depressed Kutchan's commercial and residential land and real estate prices.

In 2002, with the protracted domestic recession stultifying domestic demand, the Japanese government came up with the "Global Tourism Strategy." This formed the basis for the "Visit Japan Campaign," which set the ambitious goal of attracting 10 million foreign tourists to Japan by 2010. Where around 16 million Japanese traveled abroad annually,

foreign visitors to Japan numbered only one-third of that level, or around five million. The 'Visit Japan Campaign' sought to reduce this disparity as rapidly as possible. The government's aim was to use tourism to kick-start the economy. The Japan National Tourist Organization calculated that 10 million foreign visitors to Japan would spend 2.48 trillion yen.

In conjunction with the formulation of this campaign, the Hokkaido Government launched an international tourism promotion program in 2005 entitled "Welcome to Hokkaido," aiming to increase the number of foreign tourists from 290,000 in 2003 to 540,000 by the end of 2007.[2] Intensive advertising and upgrading of local tourist facilities saw that goal already exceeded in 2006, when 590,000 foreign tourists visited Hokkaido. Japan as a whole was visited by 8.35 million foreign tourists in 2007.[3]

Figure 2 Kutchan Tourist Inflow (1,000 persons)

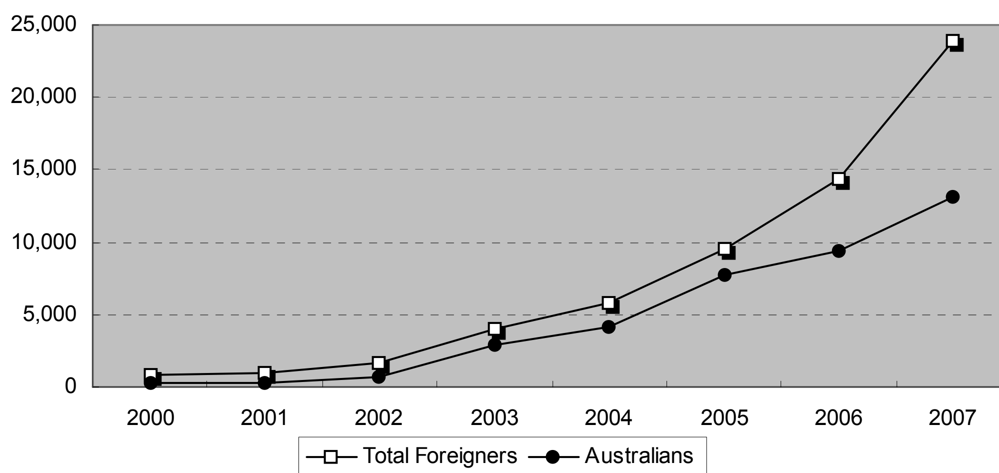


Source: Kutchan Town Office

Australian Tourists and Increased Investment

It was around 2002 when the number of Australian tourists visiting Kutchan began to increase. In 2007, Kutchan welcomed around 24,000 foreign tourists, way over the town's own population. Some 55% of these tourists were from Australia (Figure 3).

Figure 3 Foreign visitors staying in Kutchan (Number of persons)



Source: Kutchan Town Office

The number of Asian tourists from Chinese Taipei; Hong Kong, China; Singapore; and elsewhere had also been growing, but Australians were enjoying their time in Kutchan in an entirely different manner. Asian tourists primarily arrived on 3- or 4-nights ski package tours, whereas Australians came as part of family groups for longer stays averaging 7.5 nights (2006 statistics).[4] Because they stayed much longer, they tended to prefer condominium-style self-contained rooms with beds and cooking facilities.

The following factors appeared to have spurred the boom in visitors arrival from Australia to "Niseko":[5]

- The high quality of the area's natural resources, epitomized by what Australian outdoor industry businesses and tourists described as the "world's best powder snow."
- Since the events of September 11, Australians who used to go to North America during their summer months had been looking for safer ski fields. Japan's "Niseko" was increasingly being selected as their alternative destination.
- A superior location compared to Canada and Europe in terms of the time zone and the appeal of the different lifestyle and ambience that Japan had to offer (e.g. culture, food, hot springs, etc.).
- The economic boom in Australia, which has lasted for more than a decade, and the steep rise of its currency against the Japanese yen.
- Australians who have visited "Niseko" and experienced its wonderful natural environment have spread the word to other Australians, while local tour operators have also been actively promoting the area.

The rise in the number of Australian tourists had been accompanied by an influx of foreign capital and firms. As shown in Figure 4, while there were only four foreign firms in Kutchan in 2001, this had grown to 44 by 2007. Most of the foreign firms were Australian.

Foreign investors in the "Niseko" area could be roughly divided into four generations according to the date their firms were established. The first generation comprised Australians who originally came to the area as tourists, fell in love with its natural beauty, and stayed on to launch skiing, rafting and other outdoor businesses in the mid-1990s. Their testimonies spread the name of "Niseko" rapidly among other Australians. The second generation attracted by the success of the first generation, established travel services such as travel agencies and tour guide services at the end of the 1990s. The third generation consisted of tourists who came to "Niseko" using the services of the first and second generations, spotted business opportunities in the area, and set up accommodation and real estate businesses around the year 2000. Professional developers noting the success of the third generation began to move to "Niseko" around 2005. They described themselves as the fourth generation.[6]

Figure 4 Foreign firms established in Kutchan (As of the end of December 2007)

Year	Number of Firms Established
Up to 2001	4
2002	1
2003	3
2004	7
2005	7
2006	8
2007	14
Total	44

Source: Kutchan Town Office

Investment in Kutchan by Hokkaido Tracks

Hokkaido Tracks Operations

One of the trailblazers for the third generation was Hokkaido Tracks, which was quick to spot the potential of investing in "Niseko" real estate. Launched in 2003 by Australian couple Simon and Joasia Robinson, the company built and sold condominiums in the "Niseko" area.

The firm has developed 150 units in 30 blocks by the end of 2007. While each two- or three-bedroom unit was priced a steep 50 to 80 million yen (about US$420,000 to 670,000), this was still cheap compared to luxury resorts in Europe and North America. Consequently, business was booming, with all units already sold as of January 2008. The units were generally put up for sale before they were completed. Apparently, many of the buyers were foreign investors with investments all over the world who acquired "Niseko" properties as new additions to their portfolios. Rather than use their properties for vacationing, these investors rented them out to recover their investments.

To serve this need, Hokkaido Tracks established another key business as a separate firm to handle property management, condominium maintenance and rental advertising for these property owners. When a unit was rented out, the firm collected 15% to 20% of the rental fee (accommodation fee) as management commission. The property owners collected five to six percent operating yield on the units, which apparently represented a high operating ratio by international standards.

As of January 2008, not one Japanese investor had purchased a condominium from Hokkaido Tracks. Because the concept was new and unfamiliar in Japan, the Japanese tended to regard condominiums as personal-use vacation homes. As a result, they viewed the price of a "Niseko" condominium as rather expensive for that purpose. It was also foreigners who tended to rent the condominiums, with Australians dominating the winter months between December and March and an influx of Asians coming over during the Chinese New Year. In summer, however, the Japanese accounted for more than half of bookings.

Company Background and its Decision to Invest in Kutchan

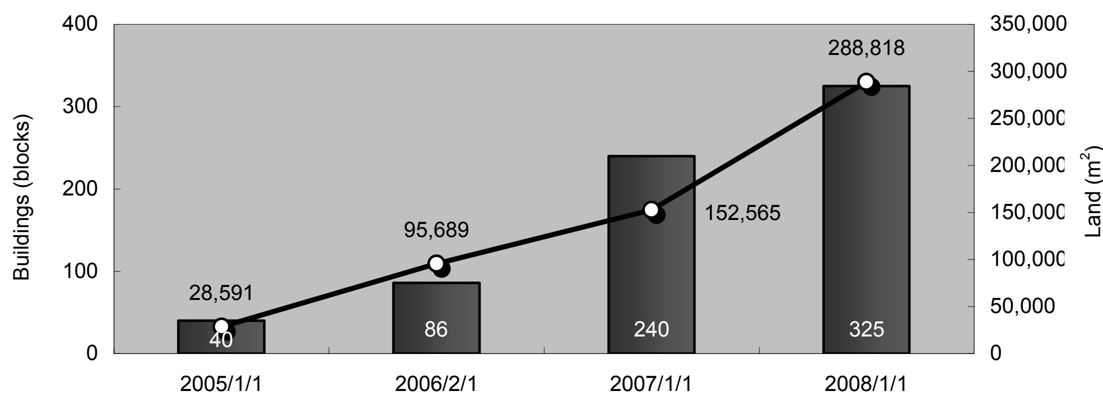
The Robinsons originally operated a restaurant in Australia's capital city of Canberra, but a massive bushfire in 2002 destroyed all their assets. On a ski trip the previous year they fell in love with the champagne powder snow of "Niseko" and decided to move there to make a new start. They set up a resort real estate company in Kutchan.

The Robinsons noted that by world standards "Niseko" area's snow was top-class, but its accommodations were poor. They decided to depart entirely from the old Japanese-oriented accommodation (ryokan inns and hotels) and instead introduced the condominium concept which had been the key to their success. This was the catalyst for a condominium-building spree among other Australian real estate firms, sparking a sudden condominium construction boom. As a result, land prices soared around the Yamada district in the town which had been the epicenter of the boom, from around 40,000 yen (about US$300) per *tsubo* (approximately 3.3 m^2) in 2003 to around 300,000 yen (US$2,500) in 2006.[7]

When the "Niseko" boom occurred in Australia, there was a lot of cheap land available. Fortunately for the investors, Japan had almost no regulations on real estate acquisition by foreigners.[8] In addition, front-running Australian entrepreneurs were already experiencing success in their local operations. The first-generation outdoor businesses in particular had

expanded the area's attractions from only skiing to include rafting, trekking and other summertime activities, gradually transforming "Niseko" into a year-round resort. Figure 5 shows the growth in the number of buildings and land acquisitions by foreigners in Kutchan.

Figure 5 Building and Land Acquisition by Foreigners in Kutchan



Source: Kutchan Town Office

Another source of attraction was the relatively short history of Hokkaido's land development, which made it more receptive to the new ideas than other parts of Japan. The Robinsons could have set up their business in Niseko Town, which was next door to Kutchan Town, but because of Kutchan's infrastructure such as waterworks, power and optical fiber networks, they ultimately elected to make their base in Kutchan. They also took into account Kutchan's superior restaurants, convenience stores and leisure facilities.

Laws and Regulations

Hokkaido Tracks had experienced remarkable growth such that in 2006 it received an award from the Director-General of the Hokkaido Bureau of Economy, Trade and Industry for promoting investment in Hokkaido and helping stimulate the local economy. The success of the company was so widely known that the names of company president Simon Robinson and Hokkaido Tracks regularly appeared in the media not only in Hokkaido but throughout Japan. Achieving this growth, however, had not necessarily been easy.

In establishing their business in Kutchan, the Robinsons sought to cover every base. They had no business experience in Japan and spoke no Japanese. They were also newcomers to the real estate business itself. Consequently, whenever a problem occurred, they consulted lawyers, administrative scriveners, the local authorities and the relevant associations to ensure that they were doing the right thing.

However, because the business model of resort condominium development and property management was entirely new to Japan, many aspects fell outside existing legal procedures. In addition, because local authorities and legal specialists had virtually no experience in working with foreign companies, unlike their counterparts in Tokyo and other big cities, it was rare to get a clear and consistent response from them. For example, when the company pursued procedures for management of investment properties as a rental company, the Kutchan town Health Protection office informed them that its activity was classified under the 'ryokan business' category (which would require securing a ryokan management license). Just to be sure, the Robinsons checked with the Municipal Health Protection office in Sapporo, which said that such properties were short-stay apartments, and therefore came under the category of rental rather than ryokan business. The Robinsons tried to avoid

management blunders by validating their information from various quarters, but differing views expressed by the various agents often led them to suspend procedures as new information came to light.

There were many instances when what foreigners perceived as ambiguities in Japanese laws (and particularly in local ordinances) brought them to grief. Western laws clearly stipulated what you could and could not do, but Japanese laws tended to take on more the nature of guidelines that focused on trust and respect, and had no punitive provisions. As a result, the Robinsons often found it difficult to know what to do. There were also a number of unwritten local business practices that were recognized only within the local community which perplexed the Robinsons.

The year 2006 saw Hokkaido Tracks business booming, with the area where its condominiums were clustered achieving the highest rate of increase in land prices in the whole of Japan. This was also the year when the Ordinance for the Protection and Fostering of Kutchan's Scenic Landscape*s* was revised. When the ordinance was first enforced in 1992, no concrete standards were stipulated, but the 2006 revisions introduced restrictions on aspects such as the building-to-land ratio and building height. The introduction of new regulations and of stricter provisions in existing regulations increased the risk for developers, but for the Robinsons, it also meant that provisions which were formerly only vague guidelines were gradually being clarified as actual rules.

To protect itself from current laws and regulations, Hokkaido Tracks had been acquiring all licenses even those with the slightest relevance. The company had secured a residential housing trading license, an authorization under the Hotel Business Law, registration under the Travel Agency Law, and an owner-driver taxi license in order to pick up and drop off guests. According to acquisitions manager, Minoru Okubo, their acquisition of all the licenses and authorizations that could possibly be relevant would be the company's strength in dealing with potential risks.

Financial System and Infrastructure

One problem that often confronted foreign entrepreneurs investing in Japan was the reluctance of Japanese banks to deal with foreigners. Because of the recession, Japanese interest rates had been kept virtually at zero for a number of years. Foreign entrepreneurs sought to take advantage of these low rates by procuring funds in Japan, but there was a strong tendency among Japanese banks to shun foreigners. Simon Robinson also struggled to find the funds for condominium development. Having safely sold off his first and second condominiums, he planned to construct two more buildings and tried to source funding from within Japan. However, Japanese banks, having suffered as a result of the Japanese economic bubble, remained suspicious of the Australian development boom in "Niseko" and refused to lend. As a result, most business funds were procured from offshore investment groups.

Other Australian entrepreneurs had struggled with this problem too. Colin Hackworth, managing director of Nihon Harmony Resorts, bemoaned the difficulty of getting financial support in Japan. Like Hokkaido Tracks, Nihon Harmony Resorts was a development firm based in Kutchan and backed by Australian capital. The company bought 180 hectares of Kutchan land from Tokyu Land Corporation in 2004. It announced a large-scale development plan for an approximately 50-billion-yen ski field with attached accommodations. While the company wanted to build a facility inspired by Canada's Whistler Resort, it was unable to find tie-up partners to provide funds, and the project remained on the drawing board. In September 2007, Hong Kong telecom major Pacific Century Cyberworks (PCCW) bought the firm and after reviewing the development plan, started to work on a new plan.[9]

Hokkaido Tracks cooperated with local developers to negotiate the financing for its development plans. In February 2008, a tie-up with a Hokkaido construction company for a new condominium and pension construction project enabled Hokkaido Tracks to take out a syndicate loan with a local bank as the agent, securing a credit line with a ceiling of 500 million yen.[10]

Another finance-related problem that the company cited was the slow pace in installing automated teller machines (ATMs) and other finance infrastructure in the area. Australian firms had constantly urged local authorities and banks for improvements, but still there were very few ATMs in Kutchan that would accept international or foreign cards. According to the "Living in Kutchan Guidebook" which the Kutchan Ward Office had put out for foreigners, there were only 12 ATMs in Kutchan. Six could take international or foreign cards (three in post offices and three in Seven-Eleven outlets), and all six were located in the center of town, some 20 minutes away by car from the area where most skiers stayed. As a result, foreign skiers did not have ready access to cash. At the same time, no more than 10% of Kutchan restaurants and stores had the facility to take credit cards.[11] For Australians in particular, who tended to come for longer periods of time, it was a case of not being able to use money even if they wanted to.

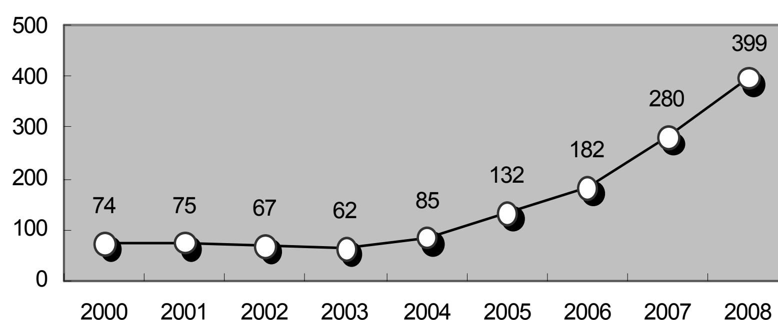
Efforts to have more ATMs accepting international or foreign cards had been continuing in Kutchan for the last 10 years, and Hokkaido Tracks had also tried petitioning and negotiating with the concerned institutions. However, because of issues with existing laws and the various procedures that needed to be undertaken, the only machines that were installed over the last decade were those in the Seven-Eleven stores which were installed in 2006.

In recent years, spurred by the increase in the number of Australian skiers coming to Kutchan, other ski areas such as Furano City have also launched active campaigns to attract foreign tourists from Australia and elsewhere. The degree by which an area was prepared as an international tourist spot to receive foreigners presumably had some impact on tourists' choice of holiday destination. Whether or not Kutchan was able to match rival ski cities as a tourist spot would also impact directly on its attractiveness as an investment destination. As such, this was an issue that Hokkaido Tracks could not afford to overlook.

Employing Staff

The "Niseko" boom brought talented professionals to Kutchan from within Japan and around the world. In January 2008, Hokkaido Tracks had 52 personnel, 40 of whom were foreigners. Most (80%) were Australians while others came from Chinese Taipei; Canada; New Zealand; the United Kingdom; and the United States. The total number of foreigners registered as living in Kutchan had likewise continued to increase annually since 2003 (Figure 6).

Figure 6 Number of foreigners registered in Kutchan (As of the end of March 2008)



Source: Kutchan Town Office

However, even if there were top-class personnel looking for jobs, getting a working visa in Japan was not easy. Working visas for one to three years were available to foreigners for the following 15 types of professions: professor, artist, religious activities, journalist, investor/business manager, legal/accounting services, medical services, researcher, instructor, engineer, specialist in humanities/international services, intra-company transferee, entertainer, skilled labor, and designated activities (the category into which working holidays fall).[12]

In the case of companies like Hokkaido Tracks, most foreign staff used 'specialist in humanities/international services' visas. However, this visa category required a certain level of academic qualification in an area related to the type of work to be undertaken, or at least 10 years' work experience in that area (at least three years in the case of interpreting, public relations, and design, etc.). With the bar set so high, it was difficult even for high-quality personnel to secure visas. In addition, ski instructors, hotel staff and many other job types associated with the tourism industry were extremely difficult to categorize under Japan's current visa system, which did not yet include working visa/working permits aimed specifically at the tourism sector.

The easiest solution was to get a working holiday visa, but because this one-time visa was intended primarily for vacation-oriented stays, it allowed only a brief 6- to 12-month stay, which was not long enough for skilled personnel to establish themselves. It was also difficult to switch over to a work visa. In the light of Japan's ambition to draw in foreign tourists, the existing regulation was at odds with the need for foreign employees in the tourism sector.

Japanese staff were no easier to employ. As of January 2008, only 20% of Hokkaido Tracks' staff were Japanese. While long-term Australian tourists tended to prefer the Western-style accommodation and facilities that they were familiar with, having come all the way to Japan, these same tourists also wanted a Japanese experience at the same time. Hence, the company wanted to employ more Japanese staff.

Thanks to the Australian-led boom, Kutchan's industry also flourished such that the number of job openings topped the number of job seekers for the first time in 14 years in 2007. This gap had since widened.[13] However, there were apparently still very few Japanese applicants for the accommodation and outdoor-related jobs offered in the business areas where Australian firms were clustered. Walker Scott, who ran Scott Adventure Sports in Kutchan, claimed that this was because leisure-related jobs such as working at a hotel or as a ski instructor were not regarded as proper "careers" in Japan. Historically, long-term employment relationships were valued in Japan, and high job mobility which was a typical characteristic for employment in the tourism sector was not conceived positively. Foreign entrepreneurs willing to hire Japanese employees should approach the employment issues in the context of the cultural preference for stable employment.

Relations with the Local Community

Resort Image

The condominiums built by Hokkaido Tracks and other foreign firms stood out because of their strong design component and unique appearance. This level of variation in architecture was important in attracting foreigners who had firsthand experience of resorts around the world. In Tokyo and other big Japanese cities, this type of structures could doubtless have been welcomed with open arms as "designer apartments." However, in Kutchan, where ski accommodation facilities had traditionally been earth-colored wooden buildings with steep

roofs, local residents initially regarded the new condominiums as eyesores. Recently, after many rounds of discussion among townspeople, local authorities and developers, certain rules relating to building standards have been established.

Business Chances for Local Firms

Even as foreign firms rush to build condominiums in Kutchan, most of the construction work was subcontracted to businesses from other parts of Hokkaido. Local construction firms had little interest in the condominium construction work available from foreign firms despite the major business opportunities these projects represented. Kutchan firms took on only 10% of orders and projects.[14]

This reluctance was ascribed to problems that earlier arose between Hokkaido Tracks and a contracted local construction company because of differences in business practices between Australia and Japan and the misunderstandings created by the language difference. The local company ended up having to cover the costs for additional work. Already struggling with shaky finances, it subsequently went bankrupt.

Other local firms observing this incident decided that dealing with foreign firms was too difficult and too risky. Foreign firms, on the other hand, generally did not believe that local firms had the technological acumen or the experience to execute their designs, which was another reason why local contracting had not been increasing.

Hence, in addition to breaking down the language barrier and improving understanding of differences in business practices, another key issue that needs to be addressed is the enhancement of local firms' capacities in terms of technology, global design and proposal preparation.

Impact on Local Lifestyles

Since 2004, the growing number of foreign visitors to Kutchan had spurred a succession of problems involving foreigners. Buoyed by the sense of freedom that tended to accompany a trip away from home, there had been cases of foreign travelers in restaurants partying loudly into the small hours, and fighting or picking quarrels with local Japanese. Most of these incidents were too minor to require reporting to the police.

The growing number of foreigners settling in for long stays at condominiums also meant an ongoing stream of nuisance behavior, such as putting out unseparated garbage. Since concerned locals launched a town patrol in conjunction with the local police in 2006, the number of incidents had dropped to a third of the peak level.[15] The "Living in Kutchan Guidebook," a free English pamphlet created by the Kutchan Town Office for foreigners on long stays, also provided at a glance all the information necessary to get by in Kutchan, including the correct method of garbage disposal and the necessary administrative procedures.

Though Japan itself was a high income economy and had seen a lot of incoming foreign direct investment as well as foreigners, Kutchan was still a relatively rural town with traditional values. Since the town was not dependent on inbound tourism in a major way in the past, there were times when local residents could not disguise their discomfort with the sudden influx of Australians and other foreigners and their new buildings. However, they also recognized the fact that the local economy benefited from these foreign visitors as a replacement for the dwindling number of Japanese visitors; hence, many wanted to co-exist in harmony with the foreigners who came to Kutchan.

Kutchan Town Office's Role

While Kutchan became the sister city of St Moritz, one of Switzerland's top health resorts, in 1964 and was also hailed as the 'Oriental St Moritz', the town traditionally put little effort into attracting foreign tourists. In recent years, it started running campaigns offshore to bring in tourists from Chinese Taipei; Hong Kong, China; and elsewhere in East Asia. However, the current influx of foreign investment was entirely unforeseen. At first, town authorities tended to sit back and watch bemused as Australian firms poured in, without any local encouragement. In more recent times, the local government had been working hard to attract investment, including holding an investment seminar in Sydney in October 2007 in conjunction with Austrade, an Australian government agency helping Australian companies succeed in trade and international business.

This trend reflected the recent strong realization on the part of local government of the major economic benefits offered by an increase in foreign tourists and an influx of foreign firms like Hokkaido Tracks. The Japan External Trade Organization (JETRO) calculated that condominium construction, tourist accommodation and other tourism-related activities in "Niseko" had created an economic ripple effect of 10.5 billion yen and 600 new jobs from 2003 to 2005. Even greater economic and employment effects were believed to have occurred in 2006 and 2007 when condominium construction and tourist influx increased still further. According to the Kutchan Town Office, where the job openings to jobseekers ratio in February 2008 was only 0.53 for all of Hokkaido, Kutchan outperformed the rest of the island with a high 1.50 ratio.[16]

A string of reports noted that to promote investment, local facilities would have to be further honed to the level expected of an international tourist resort.[17] Improving not only ATMs, waterworks, transport networks and other physical infrastructure, but also hospitals, restaurants, supermarkets and other such elements beyond hotels and tourism, would boost the investment appeal of the town as a whole.

At the same time, the "Niseko" area's stunning environment and scenery undoubtedly remained the major attraction of investing in Kutchan and its major selling point. This could be harmed by chaotic, unplanned development which could have serious repercussions for both the local community and developers in the future. For a long time, Kutchan placed no restrictions on land use or construction in the area where development was concentrated. However, the sudden skyrocketing of land prices prompted some developers to try to recover their expensive investments by pushing buildings up and out to the very limits of the available land area.

With local residents becoming increasingly aware of the need for protection and regulation of local sceneries, Kutchan authorities held discussions with the NPO Niseko Hirafu Beautiful Views Group, which comprised local residents, land owners and Australian firms, which became the basis for developing a set of building construction standards (floor area ratio, coverage ratio, height, etc.) for designated areas in the 2006 revision of "Ordinance for the Protection and Fostering of Kutchan's Scenic Landscapes." However, because these standards were not legally binding, the local government could not have disciplined a firm, even if the firm had constructed its building beyond the stipulated limits.

To protect local sceneries and the town's appearance on the basis of clear rules under the City Planning Law, in February 2008, the wards which were the focus of development were designated as "quasi-urban planning district." This had finally enabled the local government to regulate the construction of buildings that did not meet the town's requirements.

The establishment of new regulations such as the “quasi-urban planning district” and rule changes meant greater risk for developers and investors. However, Hokkaido Tracks and other entrepreneurs from Australia were well aware that the “Niseko” area’s natural environment and sceneries were extremely important assets both for their own business and for local residents, and were therefore very supportive of this outcome. In sharp contrast, developers and landowners from other areas in Japan who had come to take advantage of the “Niseko” boom had expressed strong opposition to the new regulations. They were concerned that the new regulations would reduce the value of the assets which they had purchased. Simon Robinson of Hokkaido Tracks warned against the kind of chaotic development that had occurred in other tourist areas of Japan to date, noting that “In Japan, they develop until they die.”

To boost Kutchan’s value as an international tourist destination, it will be vital to look at the benefits from a long-term perspective and approach town planning with the same kind of clear vision evinced at Whistler and other first-class international resorts found abroad.[18] It will be particularly important to engage in town planning in a way that respects Kutchan’s particular character. For example, the sight of Kutchan’s potato fields blooming en masse apparently leaves a deep impression on foreign tourists. It would not be wise if development were to impact on the agricultural scenery and natural environment that contribute heavily to Kutchan’s appeal.

In addition, local authorities need to develop and introduce real estate transaction-related systems to ensure that they too benefit from foreign investment. While the condominium boom had seen a sudden increase in the volume of Kutchan’s real estate, many of these new assets were owned by foreign investors living abroad. Although there was a system in place requiring offshore residents holding fixed assets in Japan to designate a Japanese citizen to manage tax payments and pay fixed asset tax, the rules were unclear and not adequately recognized by foreign investors. This resulted in cases where it was difficult for local government to extract taxes from owners. In particular, there were many cases where foreigners living abroad sold their property to other foreigners. In May 2007, there were 54 properties (23.5% of total properties) for which a tax manager had not been stipulated and fixed asset taxes remained unpaid, with outstanding taxes amounting to 2,489,200 yen (4.9%). Local authorities had since been directing owners to designate a tax manager. By April 2008, the number of foreign-owned properties with no tax manager had fallen to 10.[19]

Looking Ahead for “Niseko”

Entry of Large Firms

Foreign investment in “Niseko” continued to boom. Beginning in 2006 investment had begun to flow in from regions other than Australia. Moreover, big firms such as City Group and the PCCW Group started to come in (Figure 7). Investment from other economies as well as Australia was a good indication of the area’s growing international presence. The entry of big foreign firms could potentially threaten the business of small and medium-sized foreign firms already operating in the market. However, Hokkaido Tracks president Simon Robinson remained confident that small firms like Hokkaido Tracks would be able to maintain their competitiveness because they were closer to the community, which allowed them to identify needs more rapidly.

Figure 7 Main Non-Australian Investing Firms in "Niseko"

Firm	Investment
City Group (United States)	Acquisition of Higashiyama Prince Hotel from Seibu Holdings in Dec. 2006 (hotel management outsourced to Hilton)
PCCW Group (Hong Kong telco)	Acquisition in Aug. 2007 of Australian-backed Nihon Harmony Resort, which was planning a large-scale development in Kutchan's Hanazono Ward

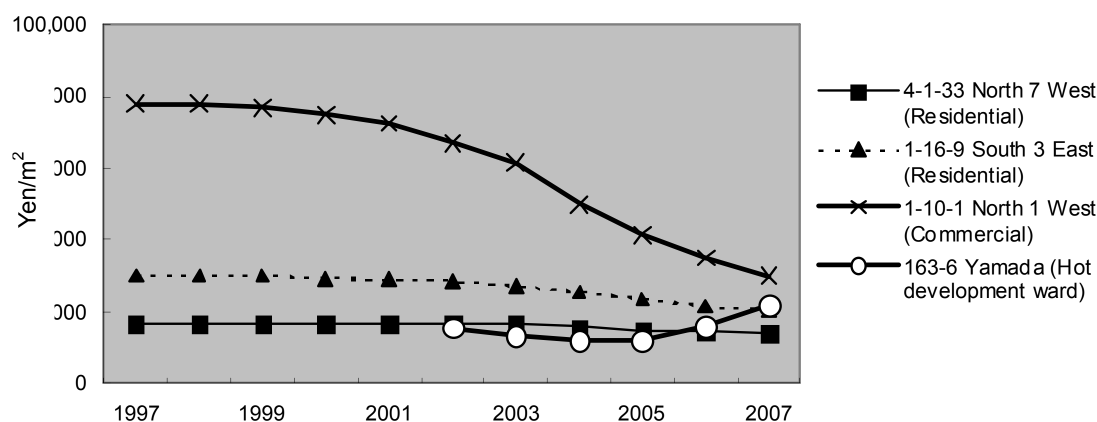
Niseko Promotion Board

Cooperation among firms in "Niseko" was also showing signs of change. In industries like tourism, it is difficult for firms to operate in isolation; what is needed is a unified local response. "Niseko" firms began forming alliances way back in 1976, when the three major local ski fields introduced joint coupon tickets for lifts on the grounds, knowing that networking among ski fields would enhance the attractiveness of the area as a whole. In 1993, this cooperation evolved into the Niseko Free Passport Council (Niseko United). Niseko United originally comprised only the three big ski fields, but in September 2007, a group of entrepreneurs operating in "Niseko" moved beyond the bounds of industry and nationality to form the Niseko Promotion Board as a limited-liability quasi-corporate body. Board membership was diverse, and included outdoor, real estate, construction and bus firms in the area. These various business types would form alliances even with rivals and beyond the bounds of nationality, and work together with town authorities to promote the "Niseko" brand and share information. Because the Promotion Board had just been launched, it remained unclear what effect it would actually have, but given the many other similar tourism-related organizations in Kutchan and the surrounding area, the Board should contribute to a stronger and more unified voice in terms of pressuring the administrative authorities, as well as ensuring the effective use of resources.

Different Interests

At the same time, there were slight differences in the degree of enthusiasm among Kutchan's local residents. In 2006, prices of land in areas at the foot of the ski fields where development was concentrated rose by 33.3% to top national residential land listings. In contrast, prices for the commercial area along the street in front of the station plunged 15.9%. In the main commercial area, many shops remained shuttered. Figure 8 presents this trend.

Figure 8 Kutchan land price trends (standard price)



Source: *Land Value Guide* (Ministry of Land, Infrastructure and Transport)

Local residents made a clear distinction between the booming development areas, which they called the mountains, and the commercial and residential land where they lived, which they regarded as the town. While the “mountains” and the “town” were only 20 minutes away from each other by car, the psychological chasm between the two ran deep. Sentiment was also divided regarding all these new developments. Some residents believed that Kutchan had been presented with a great opportunity, but others were more skeptical, viewing this as a mini-bubble which would eventually collapse and leave Kutchan a ghost town.[20] The difference in perceptions between residents and development-related parties was hampering the internationalization of Kutchan as a whole and was also detracting from the economic ripple effect. To develop the town to a level befitting an international tourist spot, the two groups would need to work together to set up mechanisms that would ensure a positive impact on the town as a whole.

Lessons learned

Customer Perspective

Investment in Kutchan by Australian entrepreneurs has spurred the revival of the area’s industry and the surrounding tourist areas from the decline caused by the collapse of the bubble economy. Kutchan attractions that could not have been discovered by the Japanese alone, such as potato flowers and mountain streams, have been revealed through foreign eyes. In addition, where Kutchan’s tourist industry once relied only on skiing and rustic hot-spring ryokan inns, the introduction of rafting and other outdoor businesses, as well as the development of condominiums as a new form of real estate, have created an influx of foreign visitors and foreign capital into Kutchan. Rural towns like Kutchan, where young people go away and the population declines even as the local economy fades, are a feature not only in Japan but in all APEC member economies. Having unique local attractions and merits revealed through the eyes of outsiders could well be a means to develop new tourism industries and stimulate regional economies.

Development of Clear Rules and Institutions

The Kutchan case shows the merits of foreign investment in the tourism industry as a means of boosting the economy of local towns. It also demonstrates that to pave the way for foreign investment, the investment risk needs to be reduced by developing the relevant legislation, fostering legal specialists, consultants and other local personnel needed to support this investment, and improving the means of local fund procurement. It is also important to match the employment needs of foreign companies with labor supply both locally and the wider domestic labor market. In addition, the Kutchan experience indicates that a proper visa/work permit system can help facilitate the engagement of foreign employees who may be vital to the international tourism industry.

Relation to the Local Community and Economy

It should also be noted that successful foreign investment hinges on the relationship with the local community. A sudden influx of foreign firms and people often makes the local community feel uneasy due to the different lifestyles they bring with them. The Kutchan experience suggests that if such cases arise, frequent discussions and close coordination between foreign companies and the local community can be helpful. In addition, proactive

support from local government and non-government groups to bring the relevant parties together to enhance understanding may be most effective. As the local community begins to appreciate the benefits of foreign investment, the chances of bringing them together will increase. As observed in the case of the local construction industry, it is often necessary to build the capacity of local business to take full advantage of the opportunities which foreign investors might bring.

Toward Sustainable Development

Looking at areas that have already achieved success as international tourist resorts, such as the Gold Coast in Australia, Whistler in Canada, and Bali in Indonesia, it is evident that they have all developed their local tourist industries through the proactive use of foreign capital. However, these first-class international resorts have not left local development just to the private sector. One key to their success is control of private investment through skilled development planning by government authorities in order to protect the natural environment and ensure the effective use of local resources. Kutchan's success will also hinge on whether the authorities, local residents and investing firms can work together to plan and implement the comprehensive development of the area as an international resort. In such cases, a key concept that can be adopted and one which also reflects a current global trend would be harmony with nature and local culture.

Endnotes

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Starting up a Hotel in Cusco

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This case was developed using information available in the public domain and those provided by PROINVERSION, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

One of the most important economic sectors in Peru was tourism. Peru had many natural, historical, archaeological resources which presented a lot of potentials for the development of tourism infrastructure, services and related industries. These business potentials constituted an opportunity for both national and foreign investors who were accorded equal treatment under existing Peruvian investment regulations. Likewise both types of investors had to face the same problems in starting a business such as land registration and the acquisition of construction permits and other forms of authorization.

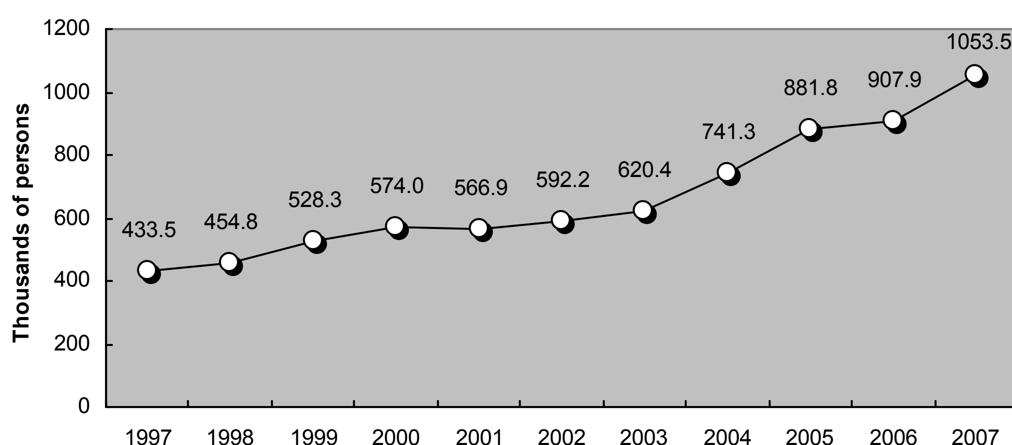
This case study examines three interrelated approval procedures for establishing a hotel in Cusco, Peru. These procedures which included the issuance of the construction permit, preparation of the Project evaluation and the conduct of the archaeological study were the responsibility of both a national body (the National Institute of Culture or "INC") and the local government authorities.

The case highlights the lack of clear guidelines on where to start the process of obtaining these project requirements as well as the absence of an administrative mechanism that could facilitate collaboration between the INC and the local government. Under these conditions, the total time spent by a potential investor in order to obtain the required authorizations was approximately 200 days.

Introduction

One of the more relevant economic sectors in Peru was tourism. According to official data, international visitors to Peru had more than doubled over the last five years, as shown in the following Figure 1.

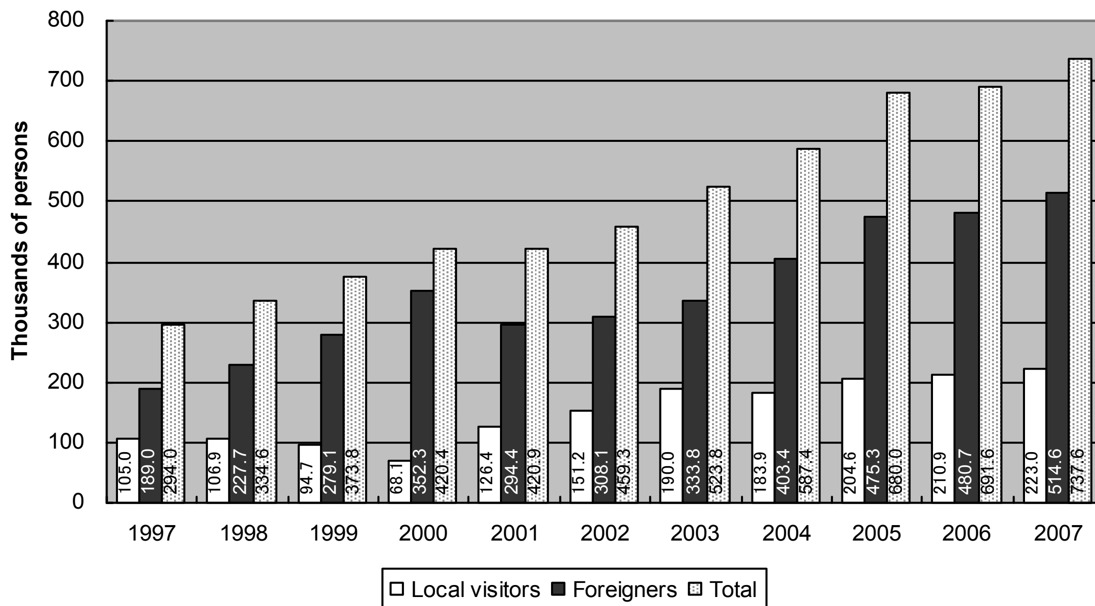
Figure 1 Foreign Arrivals at J. Chávez International Airport: 1997-2007



Source: MINCETUR

One of the most important destinations in Peru was Cusco, the cradle of the Inca civilization. Located in the southeast, Cusco was a World Heritage Site and had one of the Seven Wonders of the World, Machu Picchu, which received more than 700,000 visitors in 2007 alone. (See Figure 2 below.)

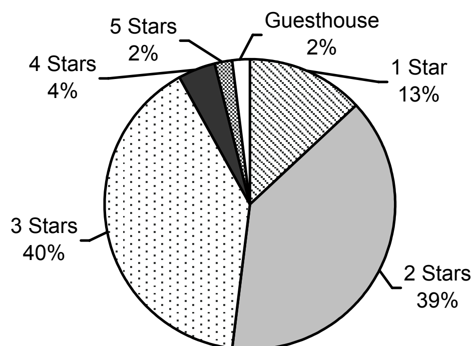
Figure 2 Number of Visitors to S.N. Machu Picchu: 1997-2007



Source: MINCETUR

Cusco accommodations offered visitors a wide range of value choices. As shown in Figure 3, majority or 40% of the hotels in Cusco were 3-star hotels, closely followed by 2-star establishments which accounted for 39%. At the high end of the price and quality range were 5-star hotels which made up 2%. At the lowest end of this range were guesthouses which represented an equal share of 2%. Hence, there were as many 5-star hotels as there were guesthouses.

Figure 3 Percent Distribution of Cusco Hotels by Category: 2007



Source: MINCETUR

If the recent trends showing an increase in the number of visitors (both foreign and local) to Cusco were to continue, the city would need to invest more in infrastructure and to improve the range of services offered to the visitors. Thus the efficiency and effectiveness of the planning and approval process for tourism-related investment would be very important. There would be a need to balance the response to the increasing demand for tourist facilities with the preservation of the region's unique heritage. Specifically, the challenge would be to reconcile the need for effective investment promotion and the facilitation of new business opportunities with the need to protect the heritage of the territories in which the historical monuments were located.

Given this context, this case focuses on the approval procedures required to establish a new hotel in downtown Cusco or more specifically the procedures related to the issuance of construction permits. The key question is whether the clearances required are sufficiently rigorous or unduly complex. To address this question, the case zeroes in on the most important approval procedures that are lodged with the following public entities: the National Culture Institute and the Provincial Government of Cusco. Information and data on the procedures were provided in part by the Investment Promotion National Agency (PROINVERSION).

Summary of Peru's Tourism Law and Regulations

According to Peruvian government sources, there were at least three institutions concerned with tourism at the national level: 1) Ministry of Foreign Trade and Tourism, 2) PROMPERU, an agency promoting tourism and exports, and 3) National Culture Institute. However if an investor wanted to build a hotel or lodge in a territory classified as a natural protection zone, he would also have to conform to the regulations of the National Institute of Natural Resources (INRENA). For example, in Aguas Calientes, a small town at the last train stop to Machu Picchu in Cusco, the hotels would have to obtain the permission of this institution as well.

The principal legislation governing the provision of tourism services was the Developed Tourism Activities Law (Law No. 26961). Together with its accompanying regulations, the law established the kinds and standards of services that could be provided to the tourists, including accommodation, restaurants, transportation, travel agencies, guides and others. However this law did not specify the procedures relating to the establishment of a hotel. At the local level, the municipalities (in the District or Province) were responsible for granting permission to build a hotel and operate the business.

Foreign Investment Legal and Institutional Framework

The Peruvian Constitutional provisions, the Law for the Promotion of the Foreign Investment (Legislative Decree No. 662), the Law for Private Investment Growth (Legislative Decree No. 757), the Law for Promotion of Private Investment in Infrastructure and Public Service Works (Supreme Decree No. 059-96-PCM), provided for non-discriminatory treatment of both foreign and domestic investments.

Foreign investment was almost unrestricted in most economic sectors. There were usually no preliminary authorization mechanisms and no performance conditions required. Peru guaranteed free transfer of capital, free competition, freedom to own private property, freedom to purchase stocks from locals, access to internal and external credit, payment of royalties, etc. Peru was also an adherent of the OECD "Declaration of International Investment and Multinational Enterprises."

At the national level, the Private Investment Promotion Agency (PROINVERSION) was responsible for promoting domestic and foreign investment together with the Ministries. At the sub-national level, Regional and Local Governments could promote investment or other kind of initiatives in their infrastructure, land, or other properties and assets. However there

could be potential problems in terms of what the National Government, the Regional or the Local Government would consider as priority sectors.

For example, at the beginning of 2008, the National Government approved Law No. 29164 to promote private investments that would improve facilities and services near archeological monuments through concessions. The content of the law raised many issues from the Regional and Local governments because there was a misunderstanding about the objectives of these measures. In Cusco, there was a 24-hour strike demanding that the government revoke the said law. This situation prompted the government to change some provisions of this law.

According to national policies, tourism was one of the most important potential investment sectors fostered by the government through the national bodies. In 2005, the government approved the National Tourism Strategic Plan (PENTUR)[1] (2008-2018). This document set up four objectives to promote sustainable tourism in order to bring about economic and social development in Peru.[2] It likewise contained an analysis of the main strengths, weaknesses, threats and opportunities of tourism development in Peru. The plan recognized the excessive bureaucracy, the lack of information for investors and the social claims (i.e. public protests, strikes) as threats facing Peru's tourism sector (which are the focus of this case study).

Overview of Peruvian Procedures to Start a Business

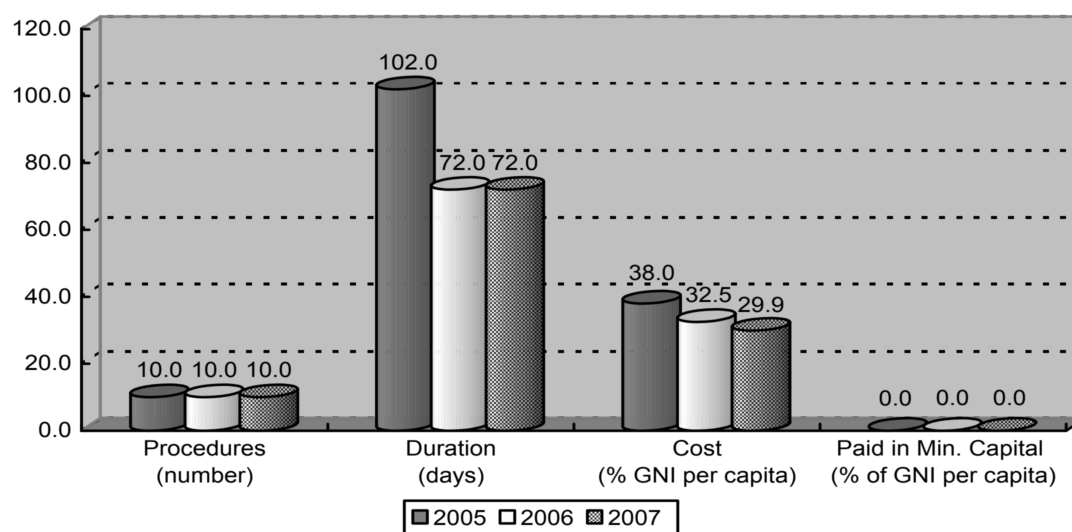
According to Peruvian law and regulations, one could identify a minimum of ten procedures that a person or company must follow to start up a business or company. The complexities of the procedures were related to the nature of the proposed business, which means that depending on the purposes of the enterprise, in addition to the general business registration requirements, other public institutions might be involved in granting permission to develop the specific economic activity. For example, if a company were interested in developing a mining project, the company had to obtain permission from the Ministry of Mining and a further authorization from the Regulation Agency of Energy, Hidrocarbs and Mining.

To give a more complete picture of what a potential investor must do to obtain the necessary clearances, it must be pointed out that there were three distinct groups of procedures that must be followed. The first group consisted of those procedures that must be undertaken to establish a new business, regardless of its type. These included business registration, taxpayer registration, and authorizations to hire staff. The second group of procedures was related specifically to the core activities of the business and was the responsibility of the national government through the appropriate ministry or public body.[3] In the case of tourism, the classification of the standard accommodation (be it a hostel or a five star hotel) was provided by the Ministry of Foreign Trade and Tourism. Finally, there was a third group of administrative procedures that fell under the responsibility of the local governments. These included the issuance of the construction permit and the operating license.

The World Bank published annual benchmarking studies that measured the ease of doing business. (APEC had agreed to link its own work program on improving the efficiency and effectiveness of internal regulations to this research.) According to the most recent *Doing Business* reports (2005, 2006 and 2007), Peru had improved its investment climate by reducing the time required to start up a business from 102 days to 72 days. The main reforms had been focused on the two procedures mentioned above which were the responsibility of the local governments, i.e., the issuance of building permits and operating licenses.

The existence of bottlenecks at the local government level, particularly in the issuance of construction permits and licenses, could in turn be traced to the Municipality Law which vested individual local authorities the autonomy to establish and regulate matters related to urban planning and local economic development within their territories. This means that the potential investor must be prepared to address different requirements and varying fees and time required to process the application, depending on where the company intended to establish its business. As indicated in Figure 4 below, there had been tangible improvements[4] in recent years in the average time required to start a business in Peru as well as in reducing the cost of doing business. These averages, however, masked differences in the time and cost of starting a business based on the location and the sector of the potential investment.

Figure 4 Peru: Starting a Business



Setting up a Hotel in Cusco

As previously cited, Cusco was the main destination of foreign and national tourists in Peru. The following case study[5] is based on a hypothetical investment decision to build a small hotel in downtown Cusco, with an area of 480 square meters at a cost of approximately US$ 115,000 to cover the construction of the building exclusive of the facilities.

Downtown Cusco was a heritage district with many designated monuments. New construction or the renovation of an existing building required the approval of the National Culture Institute (INC), in addition to clearance from the local authorities. However, there appeared to be no clear procedures for securing the required approval, because the two institutions involved in the granting of the clearance for construction had no established protocols governing the procedures. At the practical level, the potential investor had no way of knowing beforehand whether to start with the INC or with the Municipality of Cusco. This added time, cost and complexity to the application process.

The procedure in applying for a construction permit was managed by the municipality, but this in turn was related to two separate procedures overseen by the INC, namely, the "project approval" and the "archaeological study evaluation."

The Project Approval was an authorization given by INC in order to ensure that the construction project would not destroy or damage an archaeological site or historical place. The INC required an investor to hire an archaeologist to conduct an evaluation, if the construction would involve excavation. This was done to ensure that the work would not destroy any monument of ancient civilization. In order to obtain permission to proceed, the archaeological study evaluation must conclude that there were no archaeological relics or monuments present on the site; otherwise, the approval would not be granted.

As mentioned previously, there were no clear guidelines on where the investor should start the application process. In other words, the investor was left guessing as to what could be the most cost effective and time efficient way of going through the application process for the construction of the hotel. There were three options which a prospective investor could choose from in seeking the necessary approvals. These were as follows:

1. Start with the Construction Permit issued by the municipal authorities.
2. Start with Project Approval (granted by the INC).
3. Start with the Archaeological Evaluation Study for the INC.

In this particular case, the investor chose to begin by approaching the INC to seek Project Approval in order to obtain a positive evaluation of the proposed investment. The investor planned to approach the municipality as soon as the approval documentation had been completed.

The INC required considerable documentation in order to issue the project approval. At least six of the documentary requirements were the same as those required by the municipality for the issuance of a construction permit as follows:

a. Title to the property

b. If there is more than one owner, an authorization or permission by the other owners to undertake the construction project.

c. The following must be presented:
   - Site Diagram showing the location and area
   - *Arquitectonical* diagram (Map of the building)
   - Property registration document
   - Urbanism Parameter Certification (Urban Land Use Certification of the proposed site)
   - Description of the Architectural project

Presenting the same documentation to both the INC and the municipality to secure their respective approval represented additional cost and effort for the investor, as both authorities required original copies of the documents. While official information indicated that it would take no more than 30 days to process the application based on the regime of negative silent disapproval,[6] unofficial sources estimated that the time required would be at least 45 days. Taking into account the time required to prepare the full documentation, it was estimated that securing the approval would take a total of 109 days.

In order to prepare the full documentation, the investor would have to spend official and unofficial[7] costs amounting to around US$ 6,470.00,[8] which included the fees to process the application, and to hire a professional to prepare and/or acquire the necessary documents such as the property registration copy, other owners' authorizations (if required), etc. However, during the evaluation process of the application, the units of INC could still require the investor to present the Archaeological Study Evaluation.

Archaeological Study Evaluation

Upon filing his application for Project Approval, the investor could be required to submit an Archaeological Study Evaluation by the INC. This evaluation study was intended to protect an archaeological monument or historical site against any kind of damage or threat.

In order to carry out the evaluation, the investor must hire an accredited archaeologist, who would undertake the evaluation under the supervision of an INC staff archaeologist. To begin the process, the investor would have to pay the fee and present the archaeological proposal and copy of the property title. It is to be noted that since the copy of the property title would also have to be submitted as part of the project approval process, this requirement was tantamount to duplicating a requirement by the same institution.

An additional internal approval was required to begin the archaeological evaluation study, namely, the authorization of the INC to start the digging and study by the archaeologist. The subsequent approval stage would be based on the report of the archaeologist. Upon receiving a favorable report, the INC had to issue an administrative resolution authorizing the construction. This document had to be presented to the municipality with all the other required documents to start the construction permit procedure. The time and costs (official and not official) were approximately US$ 1,038.00 and 49 days,[9] respectively. This was exclusive of the time spent by the archaeologist in doing the archaeological study.

Construction Permit Procedure[10]

The purpose of this procedure was to ensure that a construction project was undertaken in accordance with the relevant national regulations and municipal by-laws. Hence, it required that the construction process should not only meet the stipulated technical requirement (such as occupational health and safety regulations) but also that it should be consistent with local urban planning guidelines. Because the investor in this case intended to build the hotel in a designated heritage area that was subject to the special oversight of the INC, the situation became more complex.

As noted, the investor had to present to the municipal authorities a number of documents which were also required to be submitted by the national agency such as INC. However, there was no provision for covering both requirements in a single submission.

Another barrier was the requirement that the investor should present to the municipality the Urbanism Parameter Certification,[11] a document that originated from the municipality itself, whose officials were also the source of the required information. The investor had to initiate a sub-process in order to obtain the information required for this certification. The investor must attach to the application form, diagrams signed by an engineer or architect related to electricity distribution, water/sewage, location, structures, as well as pictures of the neighborhood, soil assessment, and an environmental impact report, among others. Likewise, it was also necessary to obtain a security certification from Defensa Civil (the national entity responsible for ensuring security).

One important component of the evaluation process done by the municipality was the internal approval of the plan by a Technical Commission, a board that included the participation of an INC officer. The Technical Commission was tasked to evaluate all facets of the construction project. Hence, it had to verify whether all local requirements had been met and confirm whether the project would require the authorization of the INC since it

would be located in a national heritage area. At this stage of the process, the Technical Commission could ask the investor to start the procedure for conducting the archaeological study on its own (i.e. not through the municipality). Should the board decide that the project would be very complex, it could require the investor to secure INC approval for the entire project.

Two questions can be asked at this point. First, since the Technical Commission had an INC member, why not give the Commission the mandate to evaluate the project in its entirety instead of requiring the investor to start separate procedures to secure INC approval? Second, at the minimum, why did the municipal authorities not deliver the documents required by both organizations to the INC for the evaluation? In short, it was quite evident that the various approval processes were interconnected and yet there was no apparent effort to create a one-stop facility to facilitate the whole process.

While there are no definite answers to these questions, one may speculate that the lack of a collaboration agreement between the local government and the INC could be one of the factors that contributed to the absence of a clear demarcation of authority and alignment of policies and procedures between the two entities relative to the regulation of construction projects.

The consequences could be seen in the amount of time the investor would have to spend waiting for a response from the municipality. This could take about 60 days with official and unofficial cost of approximately US$ 1,168.

In summary, taking into account the three procedures, the potential investor would have to spend around US$ 8,000 and wait more than 200 days to obtain the permission to establish the hotel. This was considerably longer than the general benchmark for establishing a new business in Peru as reported by the World Bank, and arguably a deterrent to potential investors in the Peru tourism sector.

This state of affairs appeared to be the result of the lack of clear guidelines concerning the overlapping requirements of national and local institutions. The time required for the entire approval process was exceptionally long, probably because there was no predetermined procedure for adjudicating applications involving the coordinated effort of both institutions. The official and unofficial costs that the potential investor could incur was a sizeable amount considering the lack of clear information on the specifics of the process, such as hiring an archaeologist to conduct the evaluation study, or preparing the many technical diagrams and documents that the investor would have to present to the INC and the municipality.

Endnotes

[1] PENTUR establishes the guidelines for sustainable and competitive development of tourist activity in Peru. It also identifies the needs for public and private investments in the short, mid and long terms.

[2] In 2007, tourism generated incomes of more than US$ 2,222 millions. Source: National Strategic Tourism Plan, 2008.

[3] Since 2004 with the decentralization process, functions from the national level have been transferred to the sub-national governments (regional and local) giving them the responsibility to grant permission to some economic activities.

[4] These improvements can be explained by the approval of the frame law that simplified the Municipal License procedures for start-ups.

[5] The study was elaborated in 2006 by PROINVERSION. Since then, some regulations have changed and there had been new authorities in Cusco and in the INC.

[6] In Peru the legislation on the administrative procedures established that an application to obtain a permit could be approved in three ways: automatic approval, positive silent approval or negative silent disapproval. The last approach means that if the applicant did not receive an answer from the decision-making institution within the proscribed time, the application was considered to have been disapproved.

[7] The official costs were those established in the legal chart of procedures of the public entities, called TUPA.

[8] Data provided by PROINVERSION.

[9] Information provided by PROINVERSION.

[10] This procedure was one of the most complex and created bottlenecks for doing business. In 2007, a new law was approved by the Peruvian Congress that simplified and reduced some requirements. However in areas declared as National Heritage sites or with archaeological monuments, the INC had the authority to allow or disallow the construction or rebuild of any building.

[11] With the new legislation, municipalities were forbidden to require this document; nevertheless, in the official information of the Cusco Municipality 2008 (shown on the web page), it was still listed as a requirement.

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Reviving Foreign Investments in the Philippines: The Case of a Mining Project in Rapu-Rapu Island

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This case was developed based mostly on the information that is in the public domain, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

This case is about a mining project that was groomed as a showcase both for reviving mining investments and for responsible mining in the Philippines. The project was located in Rapu-Rapu, an island with a hilly terrain and a fragile ecosystem. The project proponent was Lafayette Mining, Ltd (LML), a publicly listed firm in Australia.

Anti-mining groups opposed the project when its proponent applied for an Environmental Compliance Certificate in 2000. In 2003, the construction of mining facilities in the island started. On the way to the project's operations, the Philippine government granted fiscal incentives and other forms of support to the flagship mining project. Ore extraction started in April 2005 while ore processing commenced in July 2005. Barely four months after ore processing operations started, the project suffered a major blow. In October 2005, two incidents of mine tailings spills occurred in the mine site. The spills, which caused fish kills and scared residents from eating seafood taken from the island's shores, prompted the Philippine government to suspend the project for an indefinite period.

In March 2006, the President of the Philippines formed a fact-finding commission to investigate the spills. Headed by an anti-mining advocate, the commission later recommended the closure of the mine. Instead of adopting the commission's recommendations, the Department of Environment and Natural Resources (DENR), which had the authority to decide the project's fate, came out with its own assessment of the project. After organizing public forums and consulting DENR and third-party experts, the DENR decided to allow the project proponent to conduct a series of test runs on the project's facilities to check the effectiveness of improvements made on environmental infrastructures. Anti-mining groups greeted the test runs with protests and petitions that permeated the cyberspace. Their campaign for the mine's closure continued even after the DENR gave the project the green light to resume operations in February 2007.

It was not a happy ending for the project proponent however. Fish kills recurred in October 2007, almost at the same time that one of its suppliers declared the firm on default for failing to settle its financial obligations. A prospective investor withdrew from the project in December 2007, prompting the LML to suspend the trading of its securities in the Australian stock exchange. In February 2008, the parent company appointed voluntary administrators to protect its assets from creditors. In the meantime, the DENR demanded that the firm allocate around US$ 3.3 million for the rehabilitation of the Rapu-Rapu mine.

In January 2004, Philippine President Gloria Macapagal-Arroyo issued Executive Order (EO) No. 270 which aimed to revive the economy's mining industry. Three years prior to the issuance of the EO, the economic contribution of mining had plunged to 2% of export revenues, from 20% in the 1970s. The EO mandated the preparation of a Mineral Action Plan (MAP) which identified 24 high-priority mining projects that would bring in an estimated US$ 6.7 billion in mining investments over the next 10 years. The Rapu-Rapu Polymetallic Project (RRPP) in the island of Rapu-Rapu[1] in Albay[2] province was one of these projects. But it differed from the rest for it was groomed as a showcase of the Philippine government's renewed drive to attract mining investments and promote responsible mining.

This case is based on the mining case series written by Julius I. Dumangas, Cristina Alarilla and Marie Kirstin De Jesus of the Ramon V. Del Rosario Center for Corporate Responsibility, Asian Institute of Management. The titles of the case series were: *Two "Mine-Tailings" Spills in Rapu-Rapu: Undermining Prospects for Sustainable Mining in the Philippines?, The Baptism of Fire: Resolving the Mining Controversy in Rapu-Rapu Island,* and *The Possibility and Challenge: Responsible Mining in Rapu-Rapu Island.*

In a press conference and dialogue with local government officials on 27 April 2005, Michael Defensor, then Secretary of the Department of Environment and Natural Resources (DENR), declared, "If something goes wrong with Rapu-Rapu, this would affect the entire mining investments in the country."[3]

Something went wrong soon after. Two incidents of mine tailings[4] spills occurred in the Rapu-Rapu mine on 11 and 31 October 2005. In both spills, mine tailings reached nearby creeks that drained into the sea killing fishes, crustaceans and other marine organisms. The spills created a "fish scare" that intensified the campaign of anti-mining groups for the closure of the mine. They also prompted the DENR to suspend the operation of the flagship mining project for an indefinite period.

Six months after it suspended the RRPP for polluting nearby bodies of water with cyanide-laden mine tailings, the DENR allowed Lafayette Philippines, Inc. (LPI), the proponent of the mining project, to conduct a test run of its ore processing facilities. The DENR believed that these test runs would help the agency decide whether to close the project permanently or allow it to resume operations.

Environmentalists opposed the DENR's decision to authorize the test runs. They viewed the test run decision as a signal for the reopening of the mining project. They stressed the likelihood of environmental disasters posed by mining operations in an island with a hilly terrain and a fragile ecosystem. They asked a Philippine court to stop the test runs and also launched online campaigns to stop the conduct of the test runs.

But pro-mining groups said that the DENR's decision would test the effectiveness of the environmental improvements done by LPI. Company representatives expressed confidence that the mining project would eventually regain its showcase stature for responsible mining in the Philippines.

The controversy behind the RRPP made the DENR very cautious in allowing the project to resume operations, thus stretching the test run for 120 days even as LPI's financial losses mounted to Php 2.5 billion on the 15th month of the project's suspension.

Case Background

The Philippine Mining Industry

The Philippines was the fifth most mineralized economy in the world.[5] It had nine million hectares (ha) of mineralized land with established reserves of 13 metallic and 29 non-metallic minerals.[6] In the 1980s, it ranked second in gold deposits, third in copper deposits, fifth in nickel deposits, and sixth in chromate deposits. The National Economic Development Authority (NEDA) estimated that the economy had Php 47.08 trillion (US$ 840 billion) worth of mineral wealth, 10 times its annual gross domestic product (GDP) and 15 times its total foreign debt.[7]

The fall in metal prices, the lack of investments and the increased anti-mining activism of civil society reduced the economic contribution of mining. However, mining continued to generate substantial employment. In the last 25 years, the mining industry created an average of 125,000 jobs a year. In 2003, the industry paid a total of Php 5 billion in wages and benefits.[8] The government estimated that every mining job created would generate four to ten jobs in allied industries.

The Philippine government expected that the revival of mining investments would boost its budget. Revenues would come from 15 taxes and fees, including corporate income tax, excise tax on minerals produced and royalties that mining companies must pay. From 2000 to 2004, the government collected Php 13.15 billion in taxes from the industry.

Aside from boosting government revenues and creating jobs, mining investments would generate funds for the development of local communities hosting the mines. Funds would come from the mandatory allocation of 1% of milling and mining cost of mining companies for community development.

The Department of Environment and Natural Resources (DENR)

The DENR was mandated to promote both environmental protection and sustainable commercial utilization of natural resources. The Mines and Geosciences Bureau (MGB)[9], the Environmental Management Bureau (EMB)[10], and the Pollution Adjudication Board (PAB)[11] were the DENR offices that promoted and regulated mining activities.

The Philippine Mining Act (PMA) of 1995

The PMA liberalized the entry of foreign investments in mining. It was regarded as the friendliest policy towards foreign investments in mining in comparison to those of the other 70 economies that liberalized their mining laws to attract foreign investors.[12] It removed the 60:40 (Filipino:foreign) ownership rule for mining firms, thus enabling foreigners to have full control of mining projects.

It changed the mode of disposing mineral lands, from the leasehold system to the financial or technical assistance agreement (FTAA),[13] which came in the form of a mineral production sharing agreement (MPSA), co-production agreement (CA) or joint-venture agreement (JVA). Foreign companies who would invest a minimum of US$ 50 million could explore or mine an area up to 81,000 hectares for 25 to 50 years.

While designed to spur the entry of foreign investments, PMA also promoted responsible mining, corporate responsibility and community development. It integrated the principle of social acceptability to guide the design and approval of mining projects. It required mining firms to secure prior informed consent from the communities that would directly be affected by mining operations.

The PMA likewise encouraged mining companies to use best practices in sustainable development. Mining companies were required to submit an environmental impact statement (EIS), an environmental compliance certificate (ECC), environmental protection and enhancement program (EPEP) and an environmental work program (EWP). For its part, the PMA mandated the formation of a multipartite monitoring team (MMT) to check compliance and progress of mining firms with their plans to manage environmental risks.

The PMA also mandated mining firms to formulate and implement a social development management program (SDMP)[14] to ensure the development of communities hosting mining projects. Mining companies were required to allocate 1% of its milling and mining cost for the SDMP.

The Mineral Action Plan (MAP)

After the Philippine Supreme Court declared the constitutionality of the PMA, the government came up with the MAP which sought to reduce the constraints to the development of the mining industry. The MAP addressed concerns over the unfavorable investment climate, weak public acceptance of mining investments and inadequate transparency to stakeholders.

The Rapu-Rapu Polymetallic Project (RRPP)

The RRPP was operated by the Rapu-Rapu Processing, Inc. (RRPI), a subsidiary of Lafayette Philippines, Inc. (LPI). Lafayette Mining Ltd (LML), a publicly listed company in Australia, owned 74% of LPI while Malaysian firm Philco controlled the remaining 26%.[15] LPI served as a holding company since two Philippine corporations with approved MPSAs carried out the actual mining operations. The RRPP covered a surface area of 180 hectares spanning three *barangays* (villages) in Rapu-Rapu Island.

Before the cyanide spills occurred in October 2005, the RRPP was seen as a milestone in reviving the Philippine mining industry. Identified as one of the large-scale mining investments from 2001-2010, it was one of the first new mining projects approved in the economy after 15 years. Estimated project investments would reach US$ 42 million. The project would then produce copper, gold, zinc and silver valued at US$ 350 million for the initial six years of mining operation.[16] The government stood to earn revenues amounting to US$ 246 million.[17]

Construction of mining facilities in Rapu-Rapu Island began in 2003. Initial investments for the construction of the mine reached US$ 41 million in March 2004. By the end of 2005, total investments had increased to US$ 75 million. These covered the exploration costs, investments in a power facility, interest costs and other expenses. The following investors provided the funds: bank syndicate (US$ 35 million), shareholders of Lafayette Mining (US$ 23 million), LG International & KORES (US$ 10 million) and ANZ Bank (US$ 7 million).[18]

Mining operations started in April 2005. The Rapu-Rapu Minerals, Inc. (RRMI) extracted the ores while the Rapu-Rapu Processing, Inc. (RRPI) milled and processed them. LPI, which owned 40% of RRMI and 60% of RRPI, provided mining-related financial, managerial and technical services to the two companies.

Investment Incentives[19]

The Philippine government gave numerous investment incentives to the RRPP. In May 2004, Presidential Proclamation No. 625 designated 41 hectares of the area covered by the project as a special economic zone. In June 2004, the RRPP was registered with the Philippine Economic Zone Authority (PEZA). The registration with PEZA meant that the RRPP was entitled to the corporate income tax holiday for four years from the start of commercial operations. Subject to PEZA approval, the tax holiday could be extended for another three years. After the lapse of the income tax holiday, the project was entitled to the following:

- Exemption from national and local taxes and, in lieu thereof, payment of 5% final tax on gross taxable income (exempted from the expanded withholding tax);
- Additional deduction for 50% of the cost of training expenses against the 5% tax on gross income earned;

- Tax and duty free importation of merchandise, including raw materials, capital equipment, machineries and spare parts;
- Exemption from wharfage dues, export tax and impost fees;
- Value Added Tax (VAT) zero-rating of local purchases;
- Exemption from payment of any and all local government imposed fees, licenses or taxes except real estate taxes; and
- Non-fiscal incentives such as permanent resident status within the special economic zone for foreign investors, employment of foreign nationals, simplified import and export procedures.

In its report, the Rapu-Rapu Fact-Finding Commission (RRFFC) formed by the President of the Philippines to investigate the October 2005 spills, narrated that LPI's then Country Manager Roderick Watt requested the President to proclaim the mining area as a special economic zone. The RRFFC alleged that Watt mentioned in his letter to the President that the US$ 45 million in capital investments from LML of Australia and the US$ 10 million in investments from the LG Group of Korea might be put on hold indefinitely if the mining area was not declared as a special economic zone.

The RRFFC alleged that Watt advised the President that the only requirement preventing PEZA from acting on Lafayette's request for an ecozone status was the signature of Rapu-Rapu town mayor Dick Galicia on a certificate of concurrence. A few months after Watt's appeal to the President, the Office of the President proclaimed the mining area as a special economic zone. The proclamation came out amidst accusations that Lafayette submitted a fictitious Municipal Council resolution that allegedly endorsed the company's application for an ecozone status.

In its own report to validate the RRFFC's findings, the DENR said that the sharing of project benefits became grossly unfavorable to the Philippine government as a result of the project's ecozone status.[20] It said that without investment incentives the sharing of project benefits was 54% for the government and 46% for the project proponent. However, with the ecozone status, the government's share went down to 23% while that of the proponent rose to 77%.

Controversies Surrounding the Project Approval Process

The Philippine government issued several permits to LPI subsidiaries before the start of mining operations. The DENR issued the project's ECC on 12 July 2001. The MGB also approved the project proponent's EPEP. Other permits that the project proponent obtained were the following: 1) Declaration of Mining Feasibility, 2) Health of Workers Study Program, 3) Coastal Management Plan, 4) Storm Water Runoff Management Plan, 5) Solid Waste Management Plan, 6) Roadway Maintenance and Transport Management Plan, 7) Action Plan for Pier Development, 8) Foreshore Lease from the DENR and 9) Certificate of Registration from the Board of Investments (BOI).

The Rapu-Rapu Fact Finding Commission (RRFFC) which later investigated the mine tailings spills, alleged that there were anomalies behind the process of securing the project permits.[21] In its report, the RRFFC said that while the project proponent complied with the procedures in securing the legal requirements, it failed to secure the project's social acceptability. It pointed out that several local stakeholders and environmental groups opposed the issuance of these environmental permits, citing the fragile nature of the island's ecosystem, the potential for acid mine drainage (AMD) and the storms that frequented the mining area.

The RRFFC said that the DENR hastily issued the ECC to the mining proponent, despite the advice of the Philippine Senate Committee on Environment not to do so and the knowledge that some local stakeholders strongly opposed the project. The Commission said it was anomalous to hold the only public hearing on the ECC application in the premises of the mining proponent in Rapu-Rapu Island. "The Commission takes note of the sheer inaccessibility of the site, the absolute reliance on the proponent to reach the premises where the hearing was conducted and the very limited options to travel in and out of the area, so much so that anyone who participated in this public hearing must have depended entirely on LPI for transportation and accommodations."[22]

The RRFFC also made an issue of the non-inclusion of stakeholders from nearby Sorsogon province in the public consultations on the project. It said that the DENR and the mining proponent consulted only the local government units (LGUs) and stakeholders from Albay Province. The fish kills that were attributed to the mine tailings spills heavily affected the livelihood of fishermen from Sorsogon province, prompting its Representative to the Philippine Congress to seek legislative inquiries on the controversies surrounding the October 2005 spills. The Commission stressed that Philippine regulations governing applications for environmental permits concerned themselves less with the project location than with the extent of environmental impacts on one or several jurisdictions.

Philippine Government's Actions on the Mining Controversy

The first spill occurred on 11 October 2005 due to the breakdown of the main pump that transported wastewater from a detoxification plant to a mine tailings storage dam. Pump failure caused the wastewater to flow back into an "events pond" intended to contain mine tailings spills. Because the events pond was already 40% full, an estimated 20,000 liters of cyanide-laden wastewater spilled into the premises of the gold processing plant and made its way to two nearby creeks that drained into the Albay Gulf. In the afternoon of the same day, the villagers collected two kilos of fish, crustaceans and other marine life from the mouth of the said creeks.

On 31 October 2005, heavy rainfall caused the lower tailings storage dam[23] to reach critical levels. Fearing that the dam would give way, the company diverted the accumulating wastewater to nearby creeks. In the morning of the following day, the villagers collected two sacks of dead marine life along the creeks.

The spills realized the fears of anti-mining groups on the adverse impact of mining in Rapu-Rapu Island. These spills prompted the environmental activists to intensify their campaign for the closure of the Rapu-Rapu mine. In the meantime, foreign investors closely observed the government's actions to manage the controversy behind the flagship project that would revive the mining industry.

Indefinite Suspension of the RRPP

A day after the first spill on 11 October 2005, the DENR ordered LPI to suspend its ore processing operations and comply with nine conditions to prevent another spill. These conditions included the immediate repair of the wastewater pumps, improvement of the mill's storm drainage to prevent the mixing of rainwater with wastewater and the regular draining of the events pond.

On 17 October 2005, the DENR allowed the company to resume its operations after validating the company's compliance with its recommended measures to prevent the recurrence of another spill. In its later assessment of the RRPP, the DENR admitted that it focused on the immediate cause of the first spill, but failed to note deficiencies in the company's environmental infrastructures. These deficiencies led to the occurrence of the second spill on 31 October 2005.

On 7 November 2005, the agency required LPI to submit a geotechnical evaluation of the capacity and integrity of the tailings storage facility and a detailed rehabilitation plan for the affected drainage system, and to correct the deficiency in the cyanide-detoxification circuit. It reminded the company to make sure that the cyanide level of mine wastewater was always within DENR standards. At the same time, it also ordered the company to compensate the fishermen whose livelihoods were affected by the fish scare caused by the fish kills.

On 9 November 2005, the DENR suspended the company's wastewater discharge permit and use of cyanide and slapped it with a Php 300,000 fine for violating ECC conditions. In its subsequent investigations, the agency identified major lapses of LPI such as starting commercial mining operations without completing the required environmental protection dams and non-implementation of its plans to manage environmental risks.

On 9 January 2006, the PAB, a quasi-judicial body chaired by the DENR Secretary, issued a Cease-and-Desist Order (CDO) on Lafayette's mining operations. It ordered LPI to pay a fine of Php 10.4 million, the biggest fine ever imposed by the DENR on any company violating the Philippine Clean Water Act. The DENR Secretary Michael Defensor, who signed the order, explained the DENR's move. "The rationale of imposing the maximum amount of fines is to deter similar occurrences. While government recognizes and promotes the mining industry, this should not be interpreted as a license to operate in a manner that will undermine the efforts of the DENR in protecting the environment."[24]

The DENR imposed several conditions for the lifting of the CDO. These included the submission and acceptance of a certification from the International Organization for Standardization (ISO) on the company's Environmental Management System, as well as a Comprehensive Pollution Control Program. It also required the company to employ an accredited Pollution Control Officer and to post a surety bond equivalent to 25% of the total cost of the pollution control program.

LPI's mining operations in Rapu-Rapu Island was still suspended when President Arroyo appointed retired General Angelo Reyes as new DENR Secretary in February 2006.

Formation of a Presidential Fact-Finding Commission

On 2 February 2006, President Arroyo visited Albay province and announced her plan to form a Presidential fact-finding body to investigate the spills. Her announcement followed media reports in mid-January 2006 that Bishop Arturo Bastes, an anti-mining advocate of Sorsogon, would seek the help of the influential Catholic Bishops Conference of the Philippines (CBCP) in closing the Rapu-Rapu mine. The powerful CBCP earlier raised an uproar over the two spills that disrupted the livelihood of fishermen in Albay and Sorsogon.

On 10 March 2006, President Arroyo created the Rapu-Rapu Fact Finding Commission (RRFFC) through Administrative Order 145, which mandated the commission to investigate the effects of the mining operations of LPI on people's health and environmental safety in Rapu-Rapu Island and nearby municipalities. The order also mandated the Presidential Commission to: 1) investigate the proximate and contributory causes, factors and circumstances surrounding the spills; 2) conduct baseline and social investigations; 3) assess

the effectiveness of the remedial actions undertaken by the mining proponent; and 4) recommend technical, legal and other remedial courses of actions.[25]

Bishop Bastes chaired the RRFFC and was one of the first who opposed the mining project in Rapu-Rapu, citing its very fragile ecosystem. He earlier took the position that until a proper technology was found to ensure environmental safety, no mining should be allowed in the island.[26] The RRFFC held office at the CBCP building. The CBCP had articulated its anti-mining stance in various pastoral letters. Likewise, pro-mining advocates said that anti-mining individuals dominated the RRFFC's membership.

The RRFFC conducted individual and group studies for two months, from 17 March to 17 May 2006. Some of its members visited the mine site to inspect the environmental infrastructures and the creeks where the fish kills occurred. They held public hearings, inviting LPI and DENR officials, interviewed key informants, consulted various experts and reviewed studies done by independent groups. They also collectively discussed and analyzed the findings and results of the investigations.

In its report, the RRFFC questioned the MPSA between the Philippine government and LPI.[27] It said that the government would only gain minimal excise tax revenues from the MPSA, given LPI's investment incentives and that LPI would pay substantially less taxes than what was provided under the PMA. It noted the irregularities in getting the PEZA permit, citing that the company failed to secure the Rapu-Rapu municipal council's endorsement on its PEZA permit application.[28]

Despite strong and urgent clamor from business groups that LPI should be allowed to resume mining operations, the then new Environment Secretary Reyes decided to wait for the results of RRFFC's report. On 19 May 2006, the RRFFC submitted its report to President Arroyo and recommended to: 1) cancel the RRMI/RRPI PEZA Registration; 2) rescind all financial and economic incentives given to the mining proponent; 3) build the DENR's capability to manage and monitor mining operations; 4) issue a moratorium on mining in Rapu-Rapu; 5) cancel the ECC of the RRMI and RRPI; and 6) review the PMA provisions on ownership and management of mining firms to protect Philippine interest.

Stakeholders' Reactions to the RRFFC Report

Environmentalists hailed the report. Greenpeace, the international environmental lobby group, said, "It was clear early on that the Rapu-Rapu mine was an ill-conceived project, putting the area's precious marine environment at risk from toxic mine waste and siltation, and being located in an area where typhoons frequently occur and geological hazards exist."[29]

On the other hand, pro-mining groups assailed the Bastes Commission report. LPI said that the report's findings and recommendations sprang from the anti-mining bias of its members and lacked scientific bases. The Chamber of Mines of the Philippines (CMP), a lobby group for the mining industry formed in 1936, expressed dismay over the recommendations and vowed to file a petition to allow LPI to resume operations since it had complied already with government requirements.[30]

The Office of the President, which created the RRFFC itself, rejected the recommendation to ban mining in Rapu-Rapu Island. Press Secretary Ignacio Bunye said that the government would maintain its stance not to ban mining, stressing that the government must be fair with foreign investors or risk losing job-generating mining ventures. At the same time, he emphasized that the government would strictly enforce mining laws and safety standards.[31]

Generating Options in Resolving the Mining Controversy

Reyes faced a difficult decision in resolving the controversy. Since he was new to the DENR, he spent considerable time and effort to understand the mining industry. He solicited inputs and advice from DENR experts. Because the credibility of the DENR was placed in doubt because of the RRFFC findings and recommendations, Reyes also engaged academic experts, mining engineers, environmentalists and other third-party experts to help him make a sound decision on the issue.[32]

Before making a decision, he organized a public forum on 31 May 2006 at the state-owned University of the Philippines (UP), a venue deemed as a more neutral ground for discussing the issue of closing or reopening the RRPP. He invited pro-mining and anti-mining groups to this forum. LPI officials presented the company's side while a panel composed of the RRFFC members and the private sector questioned company officials. Members of the general public also asked questions during the forum.

After the UP forum, the DENR convened separate meetings with pro-mining and anti-mining groups to present and discuss DENR's options. The agency also continued to solicit additional options and added them to its list of available options which were then presented to stakeholders' groups. Reyes explained that the DENR did this to make sure that the stakeholders would not be surprised by the decision on the issue and he, in turn, would not be surprised by their reactions.

The DENR came up with its own assessment of the RRPP. In its report, the DENR pointed out that the two spills were due to human and management errors.[33] The spills could have been prevented if the company had done regular systems and equipment checks and installed the required environmental protection infrastructure before commercial operations. LPI failed to measure up to the standards of responsible mining or to use best available practices advocated by Environment Australia or by the CMP's Code of Conduct.

The DENR entertained the following five options in resolving the controversy: 1) Close the mining project, 2) Revoke the project's ECC and impose a mining moratorium in the island, 3) Maintain the temporary closure order, 4) Issue a temporary lifting order to test environmental facilities, and 5) Allow the company to resume commercial operations.

1. Close the mining project. This option was in line with the RRFFC's call. It would limit the size of the open-pit mine, reduce the area exposed to the atmosphere and thus lower the potential for AMD. It would mitigate the risk of environmental pollution from heavy metals and toxic chemicals used and generated during ore processing; reduce threats to people's health and to marine organisms; and also preserve the mineral deposits in the island for future generations.

However, it was also risky since it would leave the open-pit mine unattended and exposed to the atmosphere, thus generating AMD. The milling plant, detoxification facilities, fuel storage facilities and environmental dams would be left to deteriorate, causing environmental problems later on. Taxpayers would shoulder the environmental costs in the long run. Expensive litigation might soon follow. Also, if the company was forced to close down, the government would have to implement expensive mine site rehabilitation and environmental mitigation measures.[34] Given the rising prices of gold in the market, small-scale miners who might not follow environmental laws would mine the abandoned mining area.

The closure of the mine implied a potential loss of Php 3.1 billion in government revenues, 900 jobs in the area, and at least Php 5 million funding a year for SDMP projects. It would send a negative signal to foreign investors. NEDA Secretary Romulo Neri said that the

suspension of Lafayette "may not be advantageous to the country at the time that we are trying to attract more investments into the industry."[35]

Neri suggested the continuing operations of Lafayette under the following conditions: 1) Securing community acceptance for its continuing operations through consultations with all stakeholders under the joint supervision of the concerned local governments units and the DENR; and 2) Graduated scale of operations commensurate to its degree of compliance with the recommended environment safeguards, i.e. its level of operations must be kept within the capacity of its installed environmental safeguard features to appropriately mitigate, if not eliminate, pollution.

Alfredo Ramos of Atlas Consolidated Mining and Development Corporation said that "closing it will send a signal that there are strong anti-mining sentiments in the Philippines, whether true or not. Rather, it's a signal that they should find other countries to invest in. Indonesia is just nearby, Papua New Guinea, Australia. The problem is we're in a global market; we compete with limited capital."[36]

Brett A. Taylor, secretary of the Mindanao Association for Mineral Industries Inc., said that the resumption of the RRPP would benefit not only the company, but also the economy and the community. He said its closure could have a major impact on the perception of the Philippines as a viable investment area for mining.

J. Paul McKibben, general manager of TMM Management Inc., warned about the negative impact of Lafayette's closure on mining investments. "I talked with two international companies. They said they're not inclined to invest in the Philippines if Lafayette is closed down."[37] He added, "I believe that they should be given a second chance to demonstrate responsible practice. Given that they were fined [Php 10.7 million] already for their breaches and they paid the fine, and spent Php 400 million in remedial measures to meet conditions, they should be given a second chance. If another incident happens, they should be shut down."

2. Revoke the ECC of the project and impose a mining moratorium in Rapu-Rapu until environmental concerns are addressed. This option assumed that the design of the dam and the proposed AMD control measures were flawed. A mining moratorium would prevent the possible transfer of mining rights ownership. It would provide the opportunity to review the design of the environmental protection measures of the company and clarify the project's social acceptability, thereby raising the level of confidence of the government and of other stakeholders in the safety of mining operations in Rapu-Rapu Island. However, the company and its investors could take this decision negatively and would instead abandon the project or declare bankruptcy, leading to similar results as mine closure.[38]

3. Maintain the temporary closure order until full compliance with conditions. If the CDO remained, it would lead to similar effect as mine closure. Prolonged suspension of mining operations would strain the company's finances. It could lead to the company's bankruptcy or abandonment of the project since it was losing almost US$ 2.7 million each month in overhead costs without earning any income. It would also leave the improvements in environmental infrastructures untested.

4. Issue a temporary lifting order to test environmental facilities. The issuance of a Temporary Lifting Order (TLO) would allow the company to conduct test runs on the new base metal plant[39] and on the other improvements in environmental protection infrastructures put in place in compliance with government conditions. It would enable the government and other stakeholders to validate the adequacy of these improvements. The temporary resumption of the mining operations would also add to government revenues,

create jobs and produce community development benefits. It would demonstrate to foreign investors the friendliness of the Philippine investment climate.

On 5 May 2006, Hong Jong-ki, Ambassador of the Korean embassy in Manila, asked Reyes to grant a TLO on the RRPP in which two major Korean companies had an equity stake. Hong pointed out in his letter that the management of the RRPP already complied with the DENR's conditions. He said, "At present, all that is needed is the TLO that will allow LML to undertake commissioning tests, temporarily operate the plant and to take samples to determine whether the commissioning test results of the said project are within DENR environmental standards."[40]

Hong noted that President Roh Moo-hyun of Korea already "had articulated Korea's commitment to invest in the Philippine mining sector during his state visit to the Philippines in December 2005." The RRPP was Korea's first mining project in the Philippines and was crucial in determining Korea's future mining investments in the economy.

Robert Gregory of the Australia-New Zealand Chamber of Commerce (ANZCHAM) said that the mining industry "would like to see Lafayette resume operations as soon as practical as further delays may have a possible negative effect on Philippine mining companies' ability to attract future investment from international capital markets."[41]

Alfredo Ramos, chairman of Atlas Consolidated Mining and Development Corporation, said that the test run was crucial. He said that in the interest of the industry and of the Philippines, "environment issues should be addressed." He added, "But provided it complies with environmental measures, it should be allowed a test. The first thing is to test all the equipment, make sure their performance is according to the standard. How do you know if it works if you don't allow it to run? Now that they already complied with improved standard, with proper safety measures, government should allow them a test run and then decide afterward."[42]

However, since the equipment and environmental facilities were on a test run, the option also carried the risk of mine-tailings spills.

5. Allow the company to resume commercial operations. Adopting this option meant that revenue payments to the government would continue, aside from resuming the employment of 900 employees and producing community development benefits from SDMP funding and implementation. It would raise the confidence of foreign investors.

However, there was limited assurance of the effectiveness of the untested environmental measures and safeguards in place. There was a high risk that another mine tailings spill would recur, thus further weakening the government's credibility and lowering the public's confidence in the whole mining industry.

Test Run Decision and Its Implementation

In selecting the best option (or mix of options) to address the mining controversy, the DENR kept in mind LPI's progress in meeting the government's conditions for the resumption of mining operations. According to the DENR's report, the company substantially complied already with the 21 remedial measures and conditions, including the adoption of corrective measures to prevent future failure of wastewater pumps, detoxification plant and events pond; desilting of the polluted creeks; increase in the height of tailings storage dams; completion of the rain drainage canal; and the submission of a comprehensive EMS. There had been a complete overhaul of the company's top management and replacement of 12 out of 19 Australian executives with Filipinos.

The DENR made a cautious decision to allow the company to conduct test runs of its milling operations to determine the effectiveness of improvements in environmental facilities. It issued a 30-day TLO to determine the production efficiency of the base metal plant in processing copper and zinc, as well as to test the adequacy of remedial measures, environmental safeguards and emergency-response system. Third-party experts would observe the test run, which was also open to the public.

In justifying its decision, the DENR said, "It is the DENR's considered judgment that this option will be the best for all concerned, particularly for the Rapu-Rapu community. An abandoned open pit mine is not an attractive proposition as it will simply cause small miners to descend on the area and operate without environmental safeguards and safety measures. Without proper decommissioning, the generation of acid mine drainage will certainly continue and worsen pollution in the area. In this case, the government and ultimately the Filipino taxpayer will have to shoulder the considerable cost of remediation and rehabilitation. Allowing Lafayette to resume operations will allow an ECC-consistent mine rehabilitation and decommissioning plan to be implemented. This will also bring about economic benefits to the host communities: 900 direct jobs, Php 3 billion in government revenues (over the life of the mine) and Php 5 million per year in project commitments."[43]

To address issues raised by the RRFFC, the DENR made the following commitments: 1) Create Regional Multi-Sector Environmental Councils as venues for discussing and resolving all environmental concerns; 2) Organize Provincial Multi-Sectoral Environmental Councils to augment the monitoring function of the DENR and Multi-Partite Monitoring Team; 3) Create a multi-sectoral, multi-disciplinary group that will conduct a study on the carrying capacity of Rapu-Rapu Island to determine the merit of imposing a moratorium on mining; 4) Create a working group that will study the proposal of creating an independent Mining Authority; 5) Implement measures that will strengthen permitting procedures and improve environmental monitoring systems and standards; and 6) Conduct a review of policies to enhance responsible mining, rationalize the granting of incentives to mining operations, and enable the DENR to better perform its functions.

The DENR ordered LPI to meet the following conditions before, during and after the conduct of the test runs: 1) Pay the Php 10.4 million fine; 2) Complete environmental safeguards and instrumentations prior to the test runs; 3) Institute emergency control mechanisms in order to stop or minimize damages in case of accidents during the test run; 4) Install necessary monitoring equipment to measure the levels of cyanide, pH, and other chemicals and reagents feeding at the detoxification circuit; 5) Submit the schedule of the dam build-up for the period when the test run will be conducted; and 6) Require RRPI and RRMI to execute a Memorandum of Agreement (MOA) identifying their specific accountabilities in relation to the company's ECC conditions.

Anti-mining groups criticized the DENR's test run decision. Baconguis of Greenpeace said the 30-day test run was "a countdown to another ocean disaster."[44] But, Carlos Dominguez, LPI's new Chairman and President, welcomed the decision and said that the company was "determined to prove it stands for responsible mining."[45]

Stage 1 (10-13 July 2006). At 5pm of 10 July 2006, LPI started the first test run.[46] Water was circulated in the milling system to check for any leaks or blockages in the tailings line, raw water line, tailings return water line and the Base Metal Plant's circuits for grinding, bulk flotation, copper and zinc flotation, detoxification and filtration. Personnel from the MGB and EMB observed the test run and checked LPI's compliance with the PAB conditions. Top officials of villages directly affected by the mining project also observed the test run.

LPI opened the test run for public observation in compliance with DENR's condition. On 15 July 2006, Jesus Varela, Bishop Emeritus of Sorsogon Province, and representatives of academe, media and religious groups, toured the mine site and its facilities. LPI and the DENR monitoring team made presentations on the project to the public observers.

In his public statement, Varela said that the "DENR is the legally mandated agency of the government who will make the final decision on the fate of the company based on careful consideration of the opinion of experts, as well as the facts and scientific data that are obtained through a transparent, closely monitored and credible process, not on mere speculations and hearsay."[47] He stressed that the test run was critical in: 1) demonstrating LPI's compliance with government conditions on responsible mining; 2) showing if the objections of anti-mining groups on LPI's continued operations were valid; and 3) proving government's capability of strictly enforcing and monitoring LPI's compliance with environmental regulations and other relevant laws.

He said that the Roman Catholic Church was not against mining per se, but irresponsible mining.[48] He said that although mining was inherently risky, it could also benefit the poor. He added, "If the risks of mining in Rapu-Rapu can be reduced or substantially mitigated while the benefits can be palpably felt by its affected communities, then the company under its new Filipino management must be given a chance to conduct responsible mining; otherwise, it should be closed down."[49]

Stage 2 (18-26 July 2006). This second test run was conducted to check the performance of the mill, conveyor, pumps and other electro-mechanical systems. No chemicals were used except lime and other substances that neutralized any acid in the non-ore bearing rocks.

MGB and EMB regional office personnel monitored this stage of the test run. The DENR monitoring team reported that LPI had instituted corrective measures to minimize damages in case of spills. These measures included creating an Emergency Preparedness and Response Plan (EPRP); increasing the capacity of the events pond from 660 cubic meters to 810 cubic meters; installing audible alarms when the capacity of the events pond reached 25% and 30%; and buying four emergency tailings pumps (one that runs on diesel, one on gasoline, and two electric-driven).[50] LPI also produced a copy of the MOA between RRMI and RRPI on their joint responsibility and accountability for any and all project undertakings.

Death of marine organisms. The DENR received information on 20 July 2006 that dead marine organisms were found at the shorelines of Pagcolbon village. Its investigation confirmed the presence of dead squids, fish, starfish and other marine life.[51] The Pagcolbon shorelines were turbid at the time of the investigation and were very acidic (pH at 2.95).

The DENR also sought the help of the Bureau of Fisheries and Aquatic Resources (BFAR), which made its own investigation on 27 July 2006. The BFAR investigators interviewed some fishermen who said that the mining operations drove away the fish. They talked to the village head of Pagcolbon who said that people in his village were afraid to eat seafood. The DENR advised LPI to divert the flow of acidic waters from the old adit[52] away from Pagcolbon Creek and to coordinate with village officials in coming up with precautionary measures.

Proposed injunction on the test run. On 20 July 2006, concerned artists, TV personalities and environmental activists supported the court petition of the island's residents for a Temporary Restraining Order (TRO) against LPI and the DENR in conducting the test run.[53] Around 800 petitioners said that a third spill occurred at the Rapu-Rapu mine site.

The petitioner's lawyer, Howard Calleja, feared another environmental disaster in the island, saying that "the permit for another test run should have no effect anymore because it shows that their promises could not be fulfilled. Now they promise to be safe, but there's a third mine spill, so what are we waiting for? Are we waiting for a disaster to happen?"[54]

The TRO petition against LPI and the DENR alarmed business groups. The Federation of Philippine Industries (FPI) said that any order stopping the test run would derail the entry of foreign mining investments.[55] FPI President Jesus Arranza said that the court petition against Lafayette and the DENR "might force foreign investors to bring their money elsewhere."[56]

Stage 3 (25 August - 8 September 2006). MGB and EMB technical personnel continued to monitor the third test run. On Day 6 of this test run, the milling plant processed 1,288 metric tons of ore which was 43% of the plant's rated daily capacity. There were occasional spillages observed but LPI's technical personnel regularly cleaned them.[57]

Public observers. As of 1 September 2006, 111 individuals representing 25 organizations had observed the test run. Positive feedbacks were heard from some observers who said that "they were in favor of responsible mining." The observers suggested that LPI intensify the information, education and communications (IEC) campaign to counteract anti-mining sentiments.

Depletion of potable drinking water. The DENR reported that some residents of Pagcolbon village blamed the company's drilling activities for the depletion of potable drinking water. The DENR said that the company should address the complaint as a sign of goodwill to the host communities.[58]

Cyber-protest. To mark the end of the test run, Greenpeace launched a "cyber-protest" against Lafayette[59]and invited environmental activists to log on to www.greenpeace.org.ph and click on a banner that said, "Stop the Mine, Save our Seas." It said that the surrounding seas of Rapu-Rapu were feeding grounds for the whale shark, the biggest fish in the world and that "Greenpeace cyber-activists, who numbered in hundreds of thousands, helped foster positive changes in international regulations and forced companies to withdraw from environmentally-damaging practices."[60]

The Extended Test Run. On 11 September 2006, the PAB granted the 4 September 2006 motion of LPI to extend the test run for 60 days. Echoing the recommendation of the DENR regional offices, the PAB said that the extension would help them better assess the efficiency of the detoxification system. The PAB asked LPI to submit a schedule of activities and a list of environmental management measures during the extended test run as well as a schedule of audit of its EMS.[61]

DENR's decision again drew fire from anti-mining groups. Defend Patrimony, a nationwide alliance fighting the liberalization of the Philippine mining industry, said that the company should instead be required to get a new ECC to prove the reliability of its environmental structures.[62]

A Model Mine? Government experts hoped that the RRPP could again become a model mine after paying the price for its mistake.[63] MGB Director Horacio Ramos said that "Lafayette was supposed to be a model mine, and then something happened, and it became an embarrassment."[64] He said that the mining controversy in Rapu-Rapu did much more damage to the image of the Philippine mining industry than to the environment. The Philippine mining industry would recover if Lafayette also recovers.

Bayani Agabin, Lafayette's senior vice president for legal affairs, said that "if you look at the structures, if you look at the scrutiny which we've been subjected to, I don't know how it cannot make a better operator out of us."[65]

Towards the Green Light

Motion for Permanent Lifting Order. On 18 October 2006, LPI asked the PAB for the issuance of a Permanent Lifting Order, saying it had successfully conducted the required test runs; no adverse environmental incidents occurred during the 120-day test run.[66] It added that the quality of its water effluents were all within DENR standards during the conduct of the test run, stressing that the efficiency of its cyanide detoxification plant was 99.5% to 99.99%.[67]

Some investors already expressed interest in the RRPP after the project's prospects brightened up at the conclusion of the test runs. In October 2006, LPI announced that talks with the South East Asian Strategic Assets Fund (SEASAF) and its advisor, CIMB Standard Strategic Asset Advisors Pte. Ltd, were on the pipeline. Agabin hoped that once government gives the green light to resume commercial operations, talks with interested investors would push through.[68] LPI expected to get US$ 10 million to US$ 15 million in fresh project funding from the proposed deal.

Another 30-Day Extended Test Run. On 6 November 2006, the PAB granted LPI's request for an extension of the TLO for 30 days. It required the company to submit a week after a copy of the TWG assessment on the structural integrity of its environmental dams and the adequacy of the measures to control AMD.

A Week Before DENR's Final Lifting Order. LPI promised to secure the required ISO certification for its EMS as one of the DENR conditions for the resumption of commercial operations. Carmelita Pacis, LPI's Pollution Control Officer, said that the company already initiated the process of securing the certification to "make sure its systems are in synch with existing government rules and standards especially those in relation to the environment."[69] DENR reports also revealed that LPI had been conducting consultations and workshops on needs reassessment and its SDMP for 2007 with directly or indirectly affected villages.

On 6 February 2007, two days before the DENR's final decision, the DENR-TWG endorsed to Reyes a report on the current status of the RRPP. It recommended that "full mining and milling operations be allowed."[70] On the same day, Reyes was scheduled to visit the mine site but his helicopter was unable to land because of bad weather. He just spoke to reporters in nearby Legazpi City saying, "We went here to see to it that the tests being conducted are run with full transparency."[71]

Dominguez said that LPI successfully hurdled the DENR requirements related to reengineering works, test runs and trial operations. He said that the company's expenses for rehabilitation rose to US$ 5 million from the original estimate of US$ 2.8 million because "we even went beyond what were being asked."[72] Manuel Agcaoili, president of LPI subsidiary RRPI, said that the company's losses already reached Php 2.25 billion since the project's suspension.[73] He disclosed that the company was incurring around Php 150 million in operational losses.

Fatal Mysterious Disease. On the day Reyes was set to make a final decision, newspapers reported the deaths of five residents of Rapu-Rapu Island.[74] Anti-mining activists went to the DENR central office in Quezon City to ask Reyes to defer the decision and to investigate whether the mining operations caused those mysterious deaths. Clemente Bautista of

Kalikasan-PNE said that high fever or infection preceded the deaths and the victims suffered sudden and unexplained swelling of their bodies.

LPI branded the allegations as "baseless and irresponsible"[75] and that Kalikasan-PNE was desperate in stopping the RRPP from resuming operations. According to LPI, the Mananao village, where the deaths occurred, was 15 km away from the mine and was on the island's other side. The deaths happened two weeks before when no mining operations took place.[76] Anti-mining groups had to be blamed for using the media in unnecessarily scaring people, with "dire consequences for the poor."[77] In the past, environmental activists falsely accused the company of contaminating the coastal waters of Sorsogon province with mercury. The scare was a hoax but some 5,000 fishermen lost their livelihood overnight because people were told not to buy fish from the area.[78]

LPI said that under its new all-Filipino management, it had become "very transparent" in its efforts to meet the government's conditions for the resumption of mining operations. It appealed to the media and the public "to see through the efforts of a few misguided anti-mining advocates and not fall easily for their baseless allegations."[79]

The Green Light

Final Lifting Order. Despite calls for the investigation on the mysterious deaths in the island, Reyes finally lifted the project's suspension order on 8 February 2007.[80] He said the deaths occurred in an area far away from the Rapu-Rapu mine. He said that LPI had complied with DENR conditions and the test runs showed improvements in its systems for managing environmental risks.

Reyes also emphasized, "Lafayette had undergone rigid scrutiny. It is the only mining company to have undergone such very tight monitoring. The mine was closed for 15 months and it has gone through a 120-day test run. Lafayette went through the proverbial needle's eye before getting the DENR's lifting order."[81]

The PAB order signed by Reyes stated: "Respondent's pollution case must necessarily come to an end at one point after it has complied with all the requirements imposed by the government to guard against similar untoward incident. The environmental safeguard may not be a foolproof guaranty, but the same can be considered as more than sufficient to establish with a technical degree of certainty that incidents similar to the spill that occurred last 11 and 31 October 2005 will not happen in the future."[82]

The PAB order mandated the immediate expansion of the existing Multi-partite Monitoring Team (MMT) to include representatives from the academe, NGOs and other interested stakeholders. The expanded MMT should continuously and closely monitor the mining and milling operations of LPI.

Stakeholders' Reactions to the Government's Final Decision

Anti-Mining Groups. Anti-mining groups protested the DENR's final decision ordering the resumption of mining operations in Rapu-Rapu. Bishop Bastes condemned the decision for its "blasphemous disregard" of the findings of the Presidential Fact-finding Commission he headed.[83] Baconguis of Greenpeace said that while the decision was good for Lafayette, "it is a grim one for the coastal communities within and around Rapu-Rapu Island."[84] Bautista of Kalikasan-PNE said that "we condemn in the strongest possible terms the decision of Environment Secretary Angelo Reyes to allow Lafayette to continue its mining operations."[85]

To protest the DENR's decision, the anti-mining groups launched an international petition and "massive shame campaign" aimed at convincing Lafayette's corporate financiers to withdraw from the firm.[86] They addressed their petition to ANZ of Australia, KFSC of Korea, ABN-AMRO of the Netherlands and Standard Chartered Bank of United Kingdom.

Antonio Casetas, leader of Sagip Isla (Save the Island), said that 1,384 Rapu-Rapu residents and 60 international organizations signed the petition. He said the petition was based on Lafayette's lack of "social license"—a requirement in investment decisions under the Equator Principles, a financial industry benchmark for determining, assessing and managing social and environmental risks in project financing.[87]

Trixie Concepcion, a geologist and spokesperson for Defend Patrimony, vowed, "The fight against the Lafayette's mining reopening is far from over. We are not least appeased by Reyes's public reassurances that Lafayette Mining will no longer cause environmental damage. We'll be closely monitoring the situation in Rapu-Rapu and will continue to work for Lafayette's permanent pullout from the island."[88]

Residents and Local Officials. Villagers living near the mining site said they remained vigilant. Milo Asuncion, a village official of Pagcolbon, said, "Maybe there's nothing more we could do to oppose the mining. But we would be in favor of it, only if the mining process is done correctly."[89] Aladin Valenzuela of Linao village said he was in favor of mining because it gave jobs to the villages.

Leaders of Albay and Sorsogon provinces thanked Reyes. Albay Congressman Carlos Imperial, Albay Governor Fernando Gonzales, Sorsogon Governor Raul Lee and Sorsogon City Mayor Sally Lee said the mining project was a much-needed growth catalyst for Bicol, a region battered by three successive strong typhoons in 2006.[90] However they said that they would remain vigilant to make sure that LPI, the region's biggest investor, practices responsible mining.[91] Governor Gonzales said the resumption would generate much-needed revenues for the local and national government and position Albay as an investment destination.[92]

Lafayette Philippines. In a media statement, Dominguez said, "Our workers, suppliers and other business partners can now also look forward to the company's stability. The whole mining industry here and abroad have been watching and monitoring our progress and will definitely show heightened interest in the Philippines as an investment area."[93] He praised Reyes for the decision. "What Secretary Reyes has done is open the floodgates to investments and prosperity. This is one single official act that will have immense immediate and long-term benefits to the economy and the poor especially in the countryside where mining ventures are located."[94]

He added, "We worked long and hard for this day. It's been more than a year since we, an all-Filipino team, took over management of the Rapu-Rapu project to institute all the needed reforms to transform it into a model of responsible mining."[95] He added that the company would hire more people in preparation for increasing production and resuming mineral exports. LPI was finalizing its SDMP to improve education, sanitation, health and infrastructure, and other basic services in the project's host communities.

Prologue

Fish Kill Recurred in October 2007

In October 2007, another fish kill occurred in Rapu-Rapu. The Municipal Council of Rapu-Rapu declared the island under a state of calamity as a result of the fish kill, which affected not only the fishermen but also 80% of the town residents who got scared eating seafood from the area.[96] This fish kill was again attributed to the mining operations. However, the DENR cleared the company from any liability although it could not establish the cause of the fish kill that recurred.[97] LPI's spokesperson and legal counsel said that the dates of the reported fish kill coincided with the days when the mining operations were put on hold because of maintenance work.

Major restructuring of the project

Also in October 2007, LPI announced a major restructuring plan of the RRPP. The plan was like a buyout of the project by a banking lending group owned by Cornerstone Investors and SEASAF, a Malaysian private investment firm. As reported in the media, the initial agreement was for the new investor to buy all outstanding debt, capital interest and fees owed by the project for US$ 123 million. But in the same month, Lafayette's supplier and contractor, Leighton Contractors Philippines Inc, billed Lafayette for an outstanding debt amounting to US$ 870,000 and declared the mining proponent in default two weeks later.

The project suffered a major blow in December 2007, barely 10 months after its reopening. A major investor pulled out of the project,[98] dealing what appeared to be a fatal blow to the government's flagship mining project to revive the Philippine mining industry.

Environmentalists hailed the news of an investor pullout and the decision of publicly listed Australian firm LML to suspend the trading of its securities. They said that their local, national and international lobbying struggles against the flagship mining project were finally bearing fruit.

LML entered into voluntary administration to explore all options for either the sale of the mining operations or a restructuring and capitalization of the project.[99] Company executives denied speculations that they were closing the company and said that they would continue to operate.

In February 2008, the proponents of the RRPP filed a petition for corporate rehabilitation with a Philippine court, citing that the move was meant to conserve the company's assets in the face of outstanding debts.[100] The project incurred huge debts after it ceased operations for more than a year and could not support the scheduled payment of its loans.

In the meantime, a new DENR Secretary, Lito Atienza, replaced Reyes who became the Secretary of the Department of Energy. Atienza ordered the RRPP proponents to set aside at least Php 137 million for the environmental rehabilitation and social development of the affected areas, based on its contract commitments with the government.[101]

Abbreviations

AMD	Acid Mine Drainage
ANZCHAM	Australia New Zealand Chamber of Commerce
BOI	Board of Investments
BFAR	Bureau of Fisheries and Aquatic Resources
CBCP	Catholic Bishops Conference of the Philippines
CDO	Cease-and-Desist Order
CMP	Chamber of Mines
DENR	Department of Environment and Natural Resources
ECC	Environmental Compliance Certificate
EIA	Environmental Impact Analysis
EIS	Environmental Impact Statement
EMB	Environmental Management Bureau
EMS	Environmental Management System
EO	Executive Order
EPEP	Environmental Protection and Enhancement Program
EWP	Environmental Work Program
FPI	Federation of Philippine Industries
FTAA	Financial or Technical Assistance Agreement
GDP	Gross Domestic Product
ITH	Income Tax Holidays
IEC	information, education and communications
ISO	International Organization for Standardization
LML	Lafayette Mining Limited
LPI	Lafayette Philippines, Inc.
MAP	Mineral Action Plan
MGB	Mines and Geosciences Bureau
MMT	Multipartite Monitoring Team
MOA	Memorandum of Agreement
MPSAs	Mineral Production Sharing Agreements
NEDA	National Economic Development Authority
PAB	Pollution Adjudication Board
PEZA	Philippine Economic Zone Authority
PMA	Philippine Mining Act
TLO	Temporary Lifting Order
TRO	Temporary Restraining Order
RPPI	Rapu-Rapu Processing, Inc.
RRFFC	Rapu-Rapu Fact Finding Commission (RRFFC)
RRPP	Rapu-Rapu Polymetallic Project
RRMI	Rapu-Rapu Minerals, Inc.
SDMP	Social Development Management Program
SEASAF	South East Asian Strategic Assets Fund
TWG	Technical Working Group
UP	University of the Philippines
VAT	Value Added Tax

Endnotes

[1] Rapu Rapu is a 4th class island municipality consisting of three small islands, namely, Rapu Rapu, Batan and Guinangayan. It is the only island municipality in the province of Albay. It shares municipal fishing grounds with the municipalities of Prieto Diaz and Bacon in Sorsogon.

[2] Albay is a province of the Philippines located in the Bicol Region. Its capital is Legazpi City and the province borders the Camarines Sur to the north and Sorsogon to the south.

[3] AS Araya, "Defensor cites importance of mining project in Albay," PIA Press Release 04/27/05, 27 April 2005. Accessed at < http://www.pia.gov.ph/default.asp?m=12&sec=reader&rp=1&fi=p050427.htm&no=1&date=>.

[4] Mine tailings are waste products from the mining industry that are finely ground material left over in containment areas or discharged to receiving waters after valuable metals are extracted.

[5] Senate Economic Planning Office, *Extracting Growth from Mining,* Senate Economic Planning Office: Policy Insights PI-06-05, November 2005.

[6] *Ibid*.

[7] *Ibid*.

[8] Angelo Reyes, "Mining: Flagship Industry on the Philippines," Speech delivered by Secretary Angelo T. Reyes of the Department of Environment and Natural Resources during the Prospectors and Developers Association of Canada (PDAC) 2006 International Convention, Trade Show & Investors Exchange at the Mining Investment Show on 7 March 2006, Toronto, Canada. Accessed at <http://www.mgb.gov.ph/presentations/2006-0317pdac. htm>

[9] Under the DENR, MGB is directly in charge of the administration and disposition of the economy's mineral lands and mineral resources. It recommends to the DENR Secretary the granting of Mineral Agreements and endorses to the DENR Secretary, for approval by the President, the granting of Financial or Technical Assistance Agreements (FTAA).

[10] Under the DENR, EMB, headed by the Director and Assistant Director, advises the DENR Secretary on matters relating to environmental management, conservation, and pollution control. It also recommends legislation, formulates environment quality standards, recommends rules and regulations for environmental impact assessments, and provides technical assistance for implementation and monitoring.

[11] The PAB, a quasi-judicial body under the Environmental Management Bureau (EMB) of the DENR, oversees the adjudication of pollution cases. It is composed of the Secretary as Chairman, two (2) Undersecretaries as may be designated by the Secretary, the Director of Environmental Management Bureau, and three (3) others to be designated by the Secretary as members.

[12] Structural Adjustment Participatory Review International Network (SAPRIN), "Impact of Investment Liberalization and the Mining Act of 1995 on Indigenous Peoples, Upland Communities, and Rural Poor, and on the Environment: A Summary Report." Accessed at < http://www.saprin.org/philippines/research/phi_mining_ sum.pdf>

[13] Financial or technical assistance agreement means a contract involving financial or technical assistance for large-scale exploration, development, and utilization of mineral resources. Mining companies enter into the agreement with the Philippine government.

[14] Social Development Management Program (SDMP) refers to the comprehensive five-year plan of a Contractor/Permit Holder/Lessee authorized to conduct mining and milling operations towards the sustained improvement in the living standards of the host and neighboring communities by creating responsible, self-reliant and resource- based communities capable of developing and implementing activities in a manner consistent with the principle of people empowerment. It is a tool for the development and implementation of community programs/activities in consultation and in partnership with the host and neighboring communities.

[15] Findings and Recommendations of the Fact-Finding Commission on the Mining Operations in Rapu-Rapu Island, 19 May 2006, p. 26.

[16] Felipe F. Salvosa, "Lafayette's Rapu-Rapu mining gets special ecozone recommendation," *BusinessWorld Online*, 24 April 2004.

[17] *Ibid.*, p. 27.

[18] Profundo, "The Financing of Rapu-Rapu Project: A research paper prepared for BankTrack," 8 September 2005. Accessed at <www.banktrack.org/.../060912%20The%20financing%20of%20Rapu%20Rapu%20mine.doc>

[19] DENR Assessment of the Rapu-Rapu Polymetallic Project, p. 5.

[20] DENR Assessment of the Rapu Rapu Polymetallic Project, p. 7.

[21] *Ibid.*, p. 109.

[22] *Ibid.*, p. 110.

[23] The lower-tailings storage facility is where the dam mine tailings are stored and are further detoxified. In the

facility, mine tailings are exposed to sunlight for four to five days, which reduces the cyanide levels in compliance with the DENR standard.

[24] Mines and Geosciences Bureau, "Defensor Imposes Biggest Environmental Fines and Penalties on Lafayette," 2006. Accessed at < http://www.mgb.gov.ph/news/2006-0109fines.htm>

[25] Rapu-Rapu Fact Finding Commission Report, 2006.

[26] Interview with Bishop Arturo Bastes.

[27] A Mineral Production Sharing Agreement (MPSA) is one of the modes of mineral agreements under the Philippine Mining Act of 1995. The government grants to the contractor the exclusive right to conduct mining operations within a contract area and shares in the gross output. The contractor shall provide the financing technology, management and personnel necessary for the implementation of this agreement.

[28] *Ibid*.

[29] www.greenpeace.org/international/

[30] J. Panares and R. dela Cruz, "Probers Hit Lafayette, but NEDA Protests," 2006. Accessed at <http://www.manilastandardtoday.com>

[31] G. Kabiling, "Palace Firm on Rejecting Mining Ban, Bunye Says," *Philippines: Manila Bulletin*, 2006.

[32] Based on the Meeting with Secretary Angelo Reyes, May 2007.

[33] DENR Assessment of the Rapu-Rapu Polymetallic Project.

[34] *Ibid*.

[35] Letter of Romulo Neri to Secretary Angelo Reyes, May 2006.

[36] M. Aguiba, *Manila Bulletin Online*, 2006. Retrieved from <http://www.mb.com.ph/issues/2006/06/05/BSNS 2006060566022.html#>

[37] *Ibid*.

[38] DENR Assessment of the Rapu-Rapu Polymetallic Project.

[39] The Base Metal Plant was created after the incident in place of the Cyanide Detoxification Facility where the pumps failed in the 11 October spill.

[40] Letter of Ambassador Honh Jong-ki to Secretary Angelo Reyes, May 2006.

[41] M. Aguiba, *Manila Bulletin Online*, 2006. Retrieved from <http://www.mb.com.ph/issues/2006/06/05/BSNS 2006060566022.html#>

[42] *Ibid*.

[43] DENR Assessment of the Rapu-Rapu Polymetallic Project.

[44] Nonoy Espina, "Greenpeace Slams Lafayette Reopening," *Inquirer,* 11 July 2006. Accessed from <http://newsinfo.inquirer.net/topstories/topstories/view_article.php?article_id=9226>

[45] *Ibid.*

[46] *Memorandum of MGB Regional Director Reynulfo Juan to Secretary Angelo Reyes,* 14 July 2006.

[47] Report of EMB Regional Director Gilbert Gonzales, 4 August 2006, pp. 4-5.

[48] EMB Region V., *Monitoring Report on the RRPP*, 10-16 July 2006, p. 1.

[49] *Ibid.,* Annex A.

[50] *Memorandum of EMB Regional Director Gilbert Gonzales to Secretary Angelo Reyes*, 17 August 2006.

[51] Report of EMB Regional Director Gilbert Gonzales, 4 August 2006, p. 10.

[52] Opening of the mine pit.

[53] "Group seeks injunction vs Lafayette," *Inquirer*, 21 July 2006. Accessed from <http://newsinfo.inquirer.net/breakingnews/metroregions/view_article.php?article_id=10987>

[54] *Ibid.*

[55] "Suit vs Lafayette alarms business group," *Inquirer*, 25 July 2006. Accessed from <http://business.inquirer.net/money/breakingnews/view_ article.php?article_id=11618>

[56] *Ibid.*

[57] Report prepared by Voltaire Villadolid in behalf of the TWG, 1 September 2006.

[58] Report prepared by Voltaire Villadolid and Ramon Parafina III, 2 September 2006.

[59] Nonoy Espina, "Greenpeace launches cyber-protest vs Lafayette Mining," *INQ7.net*, 11 August 2006. Accessed from <http://newsinfo.inquirer.net/breakingnews/metroregions/view_article.php?article_id=14765>

[60]*Ibid.*

[61] Blanche Rivera, "Gov't gives Lafayette test 60-day extension," *Inquirer*, 14 September 2006. Accessed from <http://newsinfo.inquirer.net/breakingnews/metroregions/view_article.php?article_id=20913>

[62] *Ibid.*

[63] Blanche Rivera, "Polluter or Model Mine: Lafayette close to getting back in business," *Philippine Daily*

Inquirer, 8 September 2006, p. A5. Accessed from <http://newsinfo.inquirer.net/inquirerheadlines/nation/view_article. php? article_id=19734>

[64] *Ibid.*

[65] *Ibid.*

[66] *RRPI's Motion for the Issuance of a Permanent Lifting Order,* 18 October 2006.

[67] According to LPI, under PAB Rules, where there is a definite finding that the respondent's effluents have passed allowable DENR standards, the board may, upon proper motion, issue a resolution formally lifting the Cease and Desist Order and terminating the case.

[68] *Ibid*.

[69] *Ibid*.

[70] The report was signed by Horacio Ramos, MGB Director; Gilbert Gonzales, EMB Regional Director; Reynulfo Juan, Regional Executive Director of DENR and Concurrent Regional Director of MGB B, Michael Cabalda, Science Research Specialist of the MGB, and Juancho Pablo Calvez, Chief Metallurgist of the MGB Central Office.

[71] Reuters, "Rapu-Rapu ruling expected Thursday," *BusinessWorld*, 6 February 2007, p. S1-1.

[72] Othel Campos, "Rapu-Rapu ruling out shortly," *Manila Standard Today*, 6 February 2007, p. B3.

[73] Othel Campos, "Lafayette losses hit P2b," *Manila Standard Today*, 8 February 2007, p.B3.

[74] Jonathan Mayuga, "Mystery disease kills 5 on Rapu-Rapu island," *Business Mirror*, 8 February 2007, p. A3.

[75] The Philippine Star, "Anti-mining group's claims baseless, says Lafayette," 8 February 2007, p. A18.

[76] Mark Ivan Roblas, "Lafayette outfit probes death," *BusinessWorld*, 8 February 2007, p. 12.

[77] "Anti-mining group's claims baseless, says Lafayette," *The Philippine Star*, 8 February 2007, p. A18.

[78] *Ibid*.

[79] *Ibid*.

[80] Jonathan Mayuga, "Lafayette gets DENR clearance," *Business Mirror*, 9 February 2007, p. A1.

[81] *Ibid*.

[82] Final Lifting Order of the DENR, p. 3.

[83] Jonathan Mayuga, "Environmental Time Bomb, Insist Groups," *Business Mirror*, 9 February 2007, p. A1.

[84] *Ibid*.

[85] *Ibid*.

[86] Mark Ivan Roblas, "Financiers asked to withdraw from Lafayette," *BusinessWorld*, 15 February 2007. Accessed from <http://codex.bworldonline.com/php/new_webget.php?htm=07/07021544.htm&uid=aimlibrary>

[87] *Ibid*.

[88] *Ibid*.

[89] Ephraim Aguilar, "Villagers watchful of Lafayette mining," *Philippine Daily Inquirer*, 15 February 2007, p. A15.

[90] "Albay, Sorsogon bullish on Lafayette's operations," *The Philippine Star*, 15 February 2007, p. A23.

[91] "Local execs bullish as Lafayette mine restarts," *Philippine Daily Inquirer*, 14 February 2007, p. A-11.

[92] *Ibid*.

[93] Ephraim Aguilar, "Villagers watchful of Lafayette mining," *Philippine Daily Inquirer*, 15 February 2007, p. A15.

[94] Mark Ivan Roblas, "Lafayette details terms of loan from Singaporean investor," *BusinessWorld*, 22 February 2007.

[95] Ephraim Aguilar, "Villagers watchful of Lafayette mining," *Philippine Daily Inquirer*, 15 February 2007, p. A15.

[96] Gina Rodriguez, "Bishop seeks aid for villages hit by Rapu-Rapu 'fishkill'". Accessed from <http://newsinfo.inquirer.net/breakingnews/regions/view_article.php?article_id=103011>

[97] "DENR clears mine firm in fishkill," *Inquirer*. Accessed from <http://newsinfo.inquirer.net/inquirerheadlines/regions/view_article.php?article_id=98237>

[98] "Investors back out of Rapu-Rapu mining," *BusinessWorld*, 5 December 2007. Accessed from <http://codex.boworldonline.com/php/news_webget.php?htm=07/07120511.htm&uid=aimlibrary>

[99] Accessed from <http://www.delisted.com.au/Company/4793/LAFAYETTE%20MINING%20LIMITED>

[100] Eric Dorente, "Rapu-Rapu firms file rehabilitation plea at Pasig RTC." Accessed from <http://codex.bworldonline.com/php/new_webget.php?htm=08/08020746.htm&uid=aimlibrary>

[101] Eric Dorente, "Rapu-Rapu proponents told to set aside P137 million for environment, social development," 23 February 2008. Accessed form <http://codex.bworldonline.com/php/new_webget.php?htm=08/08022306.htm&uid=aimlibrary>. The new Environment Secretary is Lito Atienza. He replaced retired Gen. Angelo Reyes who ordered the project's re-opening in February 2007.

Corning (Taiwan)

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This case was developed with the cooperation of Corning (Taiwan), solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

Corning Display Technologies Taiwan (Corning (Taiwan)), a subsidiary of Corning Inc. USA, was established in 1981 and had become a major supplier of glass substrates for active matrix liquid crystal displays (LCDs) manufacturers in Chinese Taipei. Its investment experience had long been regarded as one of the most successful investment cases in Chinese Taipei. Corning (Taiwan), however, also had to face various challenges during the establishment and post-establishment stages of its factories. Given that Corning (Taiwan)'s investment in Chinese Taipei took place during the transformation period of its investment environment with respect to the development of infrastructure, the maturity of the legal system, etc., this case is highly relevant to other developing economies since it shows how foreign investors and host economies could cooperate with each other in establishing an investment-friendly environment beneficial to both parties.

This case begins by introducing the business rationale for the investment of Corning (Taiwan). It then moves on to address the four major challenges it faced (i.e. the protection of intellectual properties, infrastructure, consistency of the legal environment and human resource) and illustrates how these were solved through the cooperation among stakeholders. Finally, the case elaborates on the lessons learned from the investment experience such as the collaboration of public and private sectors to facilitate the investment, the role of science parks in foreign investment, the importance of cooperation between the central and local government, and the painstaking but worthwhile effort to improve intellectual property (IP) protection.

Introduction

Background and Profile of Corning

Corning Display Technologies Taiwan (**Corning (Taiwan)**), a subsidiary of Corning Inc. USA, was established in 1981. Corning was engaged in the production of glass substrates for active matrix liquid crystal displays (LCDs), also known as thin film transistor liquid crystal displays (TFT-LCDs). It had established two additional glass substrate plants in Southern and Central Taiwan Science Park to support the high demand of Chinese Taipei's panel makers. As of 2008, the company had already invested more than US$1 billion in its Chinese Taipei operations.

The Business Rationale for the Investment

Motivation of Investment. Corning's decision to invest in Chinese Taipei was triggered by the change in the TFT-LCD industry in the late 1990s when Chinese Taipei became an important TFT-LCD manufacturing center catering to the high demand for glass substrates.

The main business of Corning (Taiwan) during its early investment stage was trade. Corning sold several of its products to Chinese Taipei domestic companies. Corning established its main Asian base for display technologies (one of its four business categories) in Japan in the 1990s since Japan was well-known for its advanced high-level technology and engineers and for having the biggest number of interested buyers. However, this situation changed in the late 1990s when the application of TFT-LCD was extended from office equipment such as

calculators to household equipment such as computers and televisions. The change symbolized the arrival and high demand of the TFT-LCDs era.

In response to this increasing demand, more and more manufacturers joined the industry. Faced with the newly rising, highly competitive technological corporations from Korea, Japanese TFT-LCD manufacturers such as Sharp Corporation, Toshiba Corporation and Mitsubishi Electric Corporation sought to cooperate with Chinese Taipei companies and through joint ventures effected the transfer of technology to these companies. Not surprisingly, the demand for glass substrates in Chinese Taipei increased significantly. As a result, Corning contemplated the establishment of factories in Chinese Taipei to provide better services to its buyers and to reduce cost.

Phase-by-phase Investment Policy. The investment policy of Corning was based on a phase-by-phase principle as shown in their investment in Chinese Taipei. First, Corning invested in a low-end glass cutting factory which they later developed into a high-tech melting factory which fully integrated glass substrates manufacture. Second, Corning expanded their scale of investment gradually. The expansion increased the demand for water, electricity, land and other resources from time to time.

Factors Considered in the Investment Decision-making. Corning considered several factors in its investment decision-making process. These included intellectual property protection, infrastructure (i.e. power, water, road/transportation, accommodation, education, bond service etc.), legislation, enforcement, consistency of laws and human resources. Science parks presented themselves as the total solution to the difficulties faced by the company. With the assistance of relevant authorities, Corning had successively established cutting and melting factories in both the Southern and the Central Taiwan Science Parks.

Challenges Faced by Corning (Taiwan)

Although Corning (Taiwan) had been successful in this industry, the company actually had to face various challenges during the establishment and post-establishment stages of its factories in Chinese Taipei. Foremost among these were four major challenges, namely, the protection of intellectual properties (**IP**), infrastructure, consistency of legal environment, and human resources. Corning (Taiwan), however, had overcome these challenges with the assistance of the authorities in Chinese Taipei.

Protection of Intellectual Properties

Chinese Taipei had significantly amended its Patent Act,[1] Copyrights Act[2] and Trademark Act[3] in the 2000s to be consistent with the international standards of IP Protection. The Trade Secret Act[4] was promulgated in 1996.

[1] Patent Act (2003), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1J0070007 and the English version is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL011249 (last visited on 3 April 2008).

[2] Copyright Act (2007), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1J0070017 and the English version is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL011264 (last visited on 3 April 2008).

[3] Trademark Act (2003), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1J0070001 and the English version is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?

Although the legislation contains all the necessary provisions for IP protection, what really matters to investors is how these provisions are enforced. Whether relevant government agencies have full understanding of the new laws and whether the government has the policy to truly enforce such rules are critical to the effective protection of IP. It is only when actions are taken by administrative and judicial departments to enforce the laws that investors would believe that the laws are effective and feel comfortable to make investment decisions. The same thing happened in Corning's case.

When Corning established a factory in Chinese Taipei in 1999, one of its concerns was IP protection. The manufacturing process of glass substrates was mainly composed of the melting stage and the cutting stage. The core know-how was in the melting stage (the "**Know-how**") which was protected under the Trade Secret Act. Without seeing much evidence of the enforcement of relevant laws, Corning was concerned that its Know-how might be easily infringed by equipment suppliers and ex-employees and that there were no sufficient and efficient remedies to this problem. Corning thus decided to operate initially only the cutting stage of its business in Chinese Taipei.

During its initial business operation, Corning gradually built up its confidence in the Chinese Taipei environment after observing how Chinese Taipei authorities enforced IP-related laws. Corning was delighted to find out that the necessary laws were implemented and that those who infringed on IP rights were also properly prosecuted. In addition, the legislation and mechanism for implementing the non-competition clause with the employees had already been fully developed.

The above findings persuaded Corning to introduce the glass melting factory in Chinese Taipei and establish its first full manufacturing factory in the Southern Taiwan Science Park in 2003.

The Non-Competition Clause. Due to business considerations, companies sometimes elect not to apply for patents but seek protection under the trade secret laws. However, compared to patent rights, the existence and scope of trade secrets are relatively ambiguous. The plaintiff has to prove both the existence of a trade secret and the infringement of such rights. This is a great hurdle that the plaintiff has to overcome.

Non-competition restriction applied to the employees was therefore devised to solve the above-mentioned difficulties that companies faced when asserting their rights. However, the non-competition clause in employment agreements has to address several conflicting rights, such as trade secret, work freedom and labor rights. There is still no consensus on how to harmonize these conflicting rights. As a result, the validity of non-competition clauses is always challenged first in a lawsuit. Given the complexity of the fact-finding and legal interpretation of such cases, the maturity of the jurisprudence in this field plays an important role in the completeness of trade secret protection.

The Trade Secret Act of Chinese Taipei was enforced in 1996. The provisions covered all the main issues of trade secret protection identified by the legislation of economies with highly developed trade secret protection systems. However, due to the heavy burden of proof, companies lacked the incentive to bring a case to court since most believed that they had little chances of winning the case. From mid-1999 to mid-2006, only 45 trade secrets related cases were initiated in the district courts of Chinese Taipei[5] and only five were won by the

lsid=FL011233 (last visited on 3 April 2008).

[4] Trade Secret Act (1996), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1J0080028 and the English version is *available at* http://www.tipo.gov.tw/secret/law_secret/law_secret_2.asp (last visited on 3 April 2008).

[5] Oliver Hung et al., *Quantitative Analysis of the ROC Court Decisions on Trade Secret Infringements and*

plaintiffs. Even so, provisions of the Trade Secret Act were further clarified by the courts. Such clarifications enabled companies to have a better understanding of the nature of trade secrets and the prerequisite measures that they had to adopt before asserting their claim to trade secret protection.

Compared to the unpopularity of the trade secret lawsuits, legal proceedings initiated based on non-competition clauses attracted more attention. During the same period, 113 cases were initiated and 38 of them were won by the plaintiffs. Compensations for damages were granted in 37 cases and permanent injunction was granted in three cases.[6]

With the increase in cases, the courts were able to develop a more sophisticated way of determining how to reach a balance between trade secret protection and labor's freedom to work. The validity of non-competition clause, for example, was determined by the court based on five principles: 1) whether there was legitimate interest of the employer to be protected; 2) whether the original position or duty of the employee was of any significance; 3) whether the restriction imposed on the employee (such as the period and the area of such restriction) was reasonable; 4) whether there was reasonable compensation; and 5) whether the employee violated the duty of good faith.[7] These judgments and principles had two main functions. First, they showed that the laws were actually implemented and the violators would be punished. Second, the five principles provided companies with rules to follow in designing a valid and enforceable non-competition clause.

Furthermore, with the awareness of IP rights, followed by the increase in cases in this field, there was a demand from industries for an IP court composed of judges specializing in IP laws and assisted by technical examination officers. The court was expected to handle IP cases in a way that could best accommodate the needs of technology development and economic development. In response to such requirement, the Intellectual Property Court Organization Act[8] and the Intellectual Property Case Adjudication Act[9] were promulgated in early 2007.

The establishment of the Intellectual Property Court allowed a professional court to hear intellectual property cases exclusively which might as a result, improve the efficiency and effectiveness of the trial. The installation of technical examination officers,[10] who were to provide evaluation, advice and analysis of technical information, was designed to help the judges understand the complicated technology in order to reach a highly informed judgment. Besides, the device of confidentiality preservation order protected both parties from leaking trade secrets during the proceedings.[11] In addition, the motion for preservation of evidence or application for preliminary injunction provided in the Intellectual Property Case

Violation of Non-Compete Clauses, 4 TECH. L. REV. 1, 4 (2007).

[6] *Id*., at 13.

[7] See Judgment Lao-Shan Tzu No. 39 of the Supreme Court in year of 1997 and Directive (89) Tai-Lao (2) Tzu No. 0036255 of Council of Labor Affairs.

[8] Intellectual Property Court Organization Act (2007), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1A0010090, and the English version is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL042719 (last visited on 3 April 2008).

[9] Intellectual Property Case Adjudication Act (2007), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1A0030215, and the English version is *available a*t http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL042720 (last visited on 3 April 2008).

[10] *See* Intellectual Property Court Organization Act, *supra* note 9, §§15-16,

[11] *See* Intellectual Property Case Adjudication Act, *supra* note 10, §§11-15.

Adjudication Act provided plaintiffs more weapons to protect their interest while going through the procedures at the initial stage of litigation.[12]

The legislation of intellectual property laws was only a starting point; the case laws brought life to it. The serious attitude of the IP authorities and the judgments by the courts had demonstrated the determination of Chinese Taipei to enforce IP protection. Actual enforcement and good communication with potential investors were key to building the confidence of investors in this regard.

The setting up of Corning's melting factory in the Southern Taiwan Science Park at its second investment stage showed the company's affirmative attitude toward the improvement of IP protection and the Chinese Taipei authorities' close coordination with investors.

Infrastructure

In making investment decisions, Corning was primarily concerned with the sufficiency of infrastructure, land, electricity, water, road (transportation) and relevant services. Hsinchiu Science Park was the most developed science park with well-equipped facilities in Chinese Taipei. However, it was fully occupied at the time Corning (Taiwan) decided to establish a glass-cutting factory.

Fortunately, the Southern Taiwan Science Park provided a timely solution to this problem for two reasons. First, most of the TFT-LCD companies were located in the Southern Taiwan Science Park. Among them were the Chi Mei Optoelectronics Corporation (the second largest TFT-LCD manufacturer in Chinese Taipei) and HannStar Display Corporation. Furthermore, since it was designed to be an opto-electronics specialized area, the Southern Taiwan Science Park attracted companies dealing with liquid crystal and alignment layer, polarizer, color filter, photomasks, backlight module and LCM module, which were either the downstream or upstream industry of glass substrate. Therefore, by establishing the cutting factory in the Southern Taiwan Science Park, Corning (Taiwan) would enjoy the advantage of industry clustering and proximity to its customers. Second, the Southern Taiwan Science Park was ready to operate at that time.

Notwithstanding the above-mentioned advantages, Corning (Taiwan) faced difficulties, including a shortage of land, steel and electricity, during the establishment and the expansion stages. Corning resorted to the relevant departments such as the Ministry of Economic Affairs and Southern Taiwan Science Park Administration for assistance. Working as coordinator, the authorities invited the Taiwan Power Company, China Steel Corporation and other companies to come up with a solution. With their help, problems were immediately solved. The coordination by the Science Park Administration with stakeholders and the government's full support contributed to this expeditious solution.

However, just providing instant responses to the requests or needs of respective investor is not sufficient to establish a satisfactory investment environment. An educated, visionary pre-planning for science parks is also essential to address the infrastructure concerns of investors as well. This need is more pronounced in the expansion stage of investment.

Although the Southern Taiwan Science Park Administration played an important role in solving the lack of infrastructure faced by Corning (Taiwan), it had an inherent limitation in the assistance it could provide to solve the problems occurring during the expansion stage. The insufficiency of electricity faced by Corning (Taiwan) in the expansion stage was solved

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[12] *See id*. §18, (2007), R.O.C.

by negotiating with the Taiwan Power Company. But there was no solution to the lack of land and the heavy traffic, which could have been prevented by more sophisticated planning of the science parks.

Consistency of Legal Environment

Tax incentive provided under the Statute for Upgrading Industries of Chinese Taipei, by which Corning (Taiwan) enjoyed a five-year tax holiday, was a great incentive to the company's investment in Chinese Taipei. Corning's and other international enterprises' investments were evaluated based on a 10 to 20 years basis with phase-by-phase investment.

The key to effect the preferential tax treatments is the consistency of the legal environment. If the government randomly changes policy, the confidence and the interests of the investors would be severely impaired.

In order to upgrade industries and enhance economic development, tax preferential treatments were offered to newly emerging, important and strategic industries under the Statute for Upgrading Industries. Pursuant to Article 9 of the Statute for Upgrading Industries,[13] companies satisfying the criteria as newly-emerging industry were exempted from business income tax for five successive years from the start of product sales or service provision. The same benefit was accorded to subsequent expansion of such companies. The Statute for Upgrading Industries also provided flexibility for shareholders of such companies to enjoy tax preferential treatment in the form of shareholders' personal income tax deduction. This benefit was a great incentive to Corning's investment decision in Chinese Taipei. The company elected to invest in Chinese Taipei and enjoy the five-year tax holiday premium.

However in 2006 the Chinese Taipei authorities introduced a new tax regulatory reform. Prior to the enforcement of the new regulation, investors including Corning (Taiwan) raised great concerns about the impact of the new regulation on the tax holiday enjoyed by investors. Taking into consideration the need to protect foreign investments, the authorities coordinated with relevant investors such as the American Chamber of Commerce, the Association of European Chambers of Commerce and other representatives from industries, Legislative Yuan, and other sectors to come up with a solution to protect these interests. A transition clause was later provided in the final legislation in an attempt to achieve a balance of interests among the stakeholders.

The rationale to initiate this tax reform was based on fairness. Tax exemption provisions were incorporated in the Income Tax Act and other special acts such as the aforementioned Statute for Upgrading Industries. However, the abusive use of tax exemption resulted in a large tax revenue loss by the government and the over-concentration of the application of tax exemption in high revenue industries or high income workers. In response to the unfairness and duplication of tax exemption, the Ministry of Finance (**MOF**) initiated the tax reform to resolve the problems.

During the tax regulatory reform process, the Chinese Taipei authorities made considerable effort to gather the opinions of experts and stakeholders when the new laws were drafted. A research group of tax experts from the College of Law, Department of Accounting and other

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[13] *See* Statute for Upgrading Industries, §9 (2008), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/newsdetail.asp?no=1J0040016, and the English version (only updated until 2003) is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL011175 (last visited on 3 April, 2008).

colleges of the National Taiwan University were engaged by the MOF to explore the feasibility of establishing alternative minimum tax treatment in Chinese Taipei. In addition, other research groups composed of economic experts were engaged to conduct research on the impact of tax reform on income distribution and the impact of alternative minimum tax on macro-income and prices of commodities.

After obtaining a positive conclusion that the introduction of alternative minimum tax treatment would improve the uneven distribution of income of nationals without obvious impact on the prices of commodities and would promote private investment and consumption beneficial to the growth of GDP in the long-term, the MOF took the next step to establish the Tax Policy and Legal Consulting Commission of MOF. The MOF invited scholars, experts, accounting firms, law firms, foreign investment association and representatives of the Industrial Technology Research Institute of Taiwan to serve as commissioners and to provide their professional comments on different aspects such as the legislating technique, the appropriate tax rate and whether add-on or alternative minimum tax was better.

The MOF also communicated with, among others, the representatives from different industries, foreign investors and banks to understand their concerns and develop the alternatives. The Tax Reform and Citizen Common Consensus Conference was held and attended by nationals, while four other forums were held in the southern, northern and middle part of Chinese Taipei to gather the recommendations from the public. Meanwhile, six of the biggest industrial and commercial associations, including the General Chamber of Commerce, National Association of Industry and Commerce, National Federation of Industry, Electric and Electronic Manufactures Association, National Association of Small and Medium Enterprises, Taiwan Federation of Industry and some other foreign investors, proposed a number of recommendations concerning the implementation of alternative minimum tax during the Commission of Second Economic Development Consulting.

The core concept of the legislation on the Income Basic Tax Act[14] was to establish an income tax system under which individuals and corporations made basic contribution to national finance. Income exempted from the tax levy under existing legislation, including but not limited to the Statute for Upgrading Industries, Income Tax Act, Encouragement of Private Participation in Infrastructure, were added back when calculating the basic tax amount.[15]

To protect the investors' interest in the tax holidays they enjoyed under the existing laws, a transition clause was added to the final version of the Income Basic Tax Act. Pursuant to the Income Basic Tax Act, the five-year tax holidays could still be enjoyed by:

a) those who have obtained the tax exemption approval by MOF prior to the effective day of the Income Basic Tax Act (the "**Effective Date**");

b) those who have completed the investment plan and obtain the tax exemption approval by MOF within one year after the Effective Date;

c) those who have obtained the approval of investment plan issued by authorities in charge and have started the construction of investment prior to the Effective Date without changing the investment plan; and

[14] Income Basic Tax Act, §1 (2005), R.O.C., the Chinese version is *available at* http://law.moj.gov.tw/Scripts/NewsDetail.asp?no=1G0340115&FL, and the English version is *available at* http://db.lawbank.com.tw/Eng/FLAW/FLAWDAT01.asp?lsid=FL037988 (last visited on 3 April 2008).

[15] *See id.* §7.

d) those who have obtained the approval of the investment plan issued by authorities in charge and started the construction of investment within one year after the Effective Date, and completes the investment plan within three years after the approval was issued without changing the investment plan.[16]

With this transition clause, the interests of companies who had completed or obtained approval of their investment plan or had obtained tax exemption approvals were protected. Companies who were only contemplating the investment without obtaining approval or without making actual investment might reconsider whether or not to invest based on the new legislation.

From the Corning (Taiwan) case, it can be seen that complete preparatory work, good communication with stakeholders and flexibility to adopt transitional measures are the key factors in attaining this win-win result. The communication channel between the government and the investors has to be established and maintained. This way, a relationship based on trust may be developed and both parties may promptly raise and respond to any new issues.

The Center of Economic Deregulation and Innovation (**CEDI**) was established under the Council for Economic Planning and Development, Executive Yuan in 2000. One of its main tasks was to eliminate investment obstacles and analyze and coordinate economic and financial regulations. Functioning as the contact point between the investors and the government agencies in order to develop a friendly investment environment, CEDI received the recommendations of business associations and relayed these to concerned authorities. It also coordinated with different departments of government to further address the concerns of the business associations. CEDI then provided the business associations the appropriate feedback and consolidated responses to their concerns.

The Association of European Chambers of Commerce and Industry and the American Chamber of Commerce came up with proposals on some investment-related initiatives and expressed their concerns on the investment environment of Chinese Taipei each year. In the 2007-2008 "Suggestions from Association of European Chambers of Commerce and Industry," the deregulation of the service industry, tax exemption and investment promotion were cited as important issues which were valued by the government. In 2006-2007, tax exemption was cited as an issue as well. After receiving these suggestions, the MOF responded to the concerns in detail. In addition to communication via letters, the MOF also arranged meetings to facilitate the dialogue between the investors and government authorities.

The participation of these associations ensured that investors' concerns were presented in an organized way to the government. Likewise, it provided the government a chance to communicate with stakeholders to clarify the misunderstanding or to adjust their measures accordingly. Such a mechanism had played an important role in providing a favorable investment climate in the economy. The crucial elements to its success had been the maturity of the organization and the attitude of the government.

Human Resource

Corning (Taiwan) had a big demand for human resource during the different investment stages of setting up and operating its factory.

[16] See *id.* §16.

In the initial stage, many foreign technicians were needed to install the equipment since they were more experienced and familiar with the machines Corning used. However, Corning encountered some problems with the inspection and issuance of working visas to these foreign technicians due to Chinese Taipei's relatively strict regulation on the hiring of foreign technicians. The Council of Labor Affairs, Executive Yuan of Chinese Taipei provided various forms of assistance in this regard. However, as mentioned above, the policy of Corning was to invest phase-by-phase. The same workers who were tapped by Corning for equipment installation were also needed when the factory expanded from time to time. Hence, the short-term visa issued to the workers did not satisfy the need of Corning.

This issue involving foreign workers is, to some extent, particular to international enterprises with multinational teams and might have been new to the authorities. Relevant authorities, when issuing visa, may take this into consideration.

In the operation stage, Corning (Taiwan) had to recruit thousands of domestic engineers and technicians immediately, given the requirement of speed in the high-tech industry. Corning (Taiwan) successfully hired the engineers and technicians through the career fairs held all over Chinese Taipei, coordination with schools and the assistance of relevant authorities. Corning's success in recruiting high-quality labor in such a short period of time was attributed to the phasing-out of traditional industries in Chinese Taipei which left a sizeable pool of experienced workers who were ready to work with the company. With appropriate training, these workers were more than capable of doing the job in the high-tech industry.

This experience is applicable to those economies where the traditional industry is phased out. The high quality of human resources always plays an important role in attracting investment.

In addition to continuously implementing policies pursuing high-quality education to develop the optoelectronics industries, a project named “Two Trillion & Two Stars” was introduced in 2002. This project aimed to fully support the development of the semiconductor, image display, biotech and digital industries. Specialized offices were established to make the strategic plan for industry development. Concerned authorities, including the Industrial Development Bureau of Ministry of Economic Affairs and the National Science Council and Council of Labor Affairs, conducted research and projected the demand and supply of high-tech human resources regularly. Based on the information they had, the different departments then worked together to design and provide professional training to the workers to meet the needs of industries. Cooperation with universities and professional schools was another important option. With these training courses, which were tailored to the needs of industries, it was easy for companies to find qualified workers.

To attract foreign engineers that Corning needed to work in Chinese Taipei, the government improved the living conditions in the Southern Taiwan Science Park to a large degree, particularly its traffic management system, leisure facility, educational institution and the green environment.

To improve the transportation system, connecting roads to adjacent regions were completed. The Tainan Station of High Speed Rail was only fifteen minutes away from the Southern Taiwan Science Park, which made it easy to travel all over Chinese Taipei.

Three different theme parks designed to make the Southern Taiwan Science Park a more pleasant environment to work in were established, namely, the sports park, the ecological park and the historical museum. The sports park, covering more than six hectares, was projected to be fully open in 2008. The ecological park originated from a flood-control plan involving the building of ten flood-control ponds. To make the best use of the ponds, the plan was expanded to include an ecological park. The sophisticated combination of flood-prevention facilities and the ecological park provided children a chance to enjoy nature and

learn about the ecological world. The historical museum came about because the site of the Southern Taiwan Science Park was full of fossil. To strike a balance between the protection of a historical site and the development of a science park, the companies and the government worked together to build the museum to properly preserve the fossils. The above examples demonstrate Chinese Taipei's ability to better develop and increase the value of its resources.

A good educational institution was needed to attract foreign workers to stay in the Southern Taiwan Science Park. To address this, the National Nanke International Experimental High School, merging the original Nanke elementary and junior high school, was established in 2006. The establishment of the school was designed to attract foreign workers. English, Japanese and Chinese were taught in the school. With the convenience of its geographic location and specially designed courses, the school aimed to inspire the interests of students in the field of science, arts, literature and others. Judging from the success of the experience of the National Experimental High School at Hsinchu Science Park, it would not be difficult to predict that the National Nanke International Experimental High School would soon become another successful story that would also serve as an incentive for foreign and domestic workers to stay in the Southern Taiwan Science Park.

Lessons Learned

Factors Affecting Investment Decision-making: Public/Private Sector Collaboration

The investment experience of Corning (Taiwan) points out that both the public sector and the private sector play important roles in attracting foreign investment. As mentioned, the authorities of Chinese Taipei provided a friendly investment environment, including IP protection, infrastructure, tax incentives and assistance in labor recruitment. While the basic requirements of investment were easily satisfied by the government, it was, however, the private sector which made Chinese Taipei a conducive and highly attractive environment for investments.

The private sector functioned as the catalyst that facilitated the investment of Corning in Chinese Taipei for two reasons.

First, Corning (Taiwan) was encouraged to expand its investment in Chinese Taipei because of the increasing demand for glass substrates coming from Chinese Taipei TFT-LCD manufacturing companies, which were clustered in the Southern Taiwan Science Park. By establishing the cutting factory, Corning (Taiwan) would be able to enjoy the advantage of industry clusters and geographic proximity to its customers.

Second, the investment of Corning in Chinese Taipei was carried out phase-by-phase, from a low-end cutting factory to a high-tech melting factory. While establishing the cutting factory, the authorities raised some concerns on whether the cutting factory in terms of its technology level was eligible to locate in the science park. Considering the importance of the role Corning (Taiwan) played in the TFT-LCD industry supply chain, some of its client companies, which were also major TFT-LCD manufacturing companies in Chinese Taipei such as AU Optronics Corporation and Chi Mei Optoelectronics Corporation, successfully convinced the relevant authorities to permit Corning's (Taiwan) to establish a cutting factory in the Southern Taiwan Science Park. This first step of Corning's (Taiwan) investment was very important to the subsequent investments. Through its exploratory investment in Chinese Taipei, Corning (Taiwan) and the host government had a chance to know each other better and cooperate further.

This case highlights the importance of understanding how the public and the private sector cooperated with each other to provide an attractive investment environment. Although Chinese Taipei did not provide a perfect investment environment in the preliminary stage of Corning's investment, both the public and private sector of Chinese Taipei responded efficiently to satisfy the needs of the investor from time to time, which brought about the win-win result for both Corning (Taiwan) and the Chinese Taipei TFT-LCD industry.

Science Parks and Foreign Investment

This case illustrates the positive effects of science parks and how they serve as an answer to the difficulties that an incoming investor might face.

For a long time, Chinese Taipei had been studying the positive effects of science parks. The Southern Taiwan Science Park, where TFT-LCD companies were clustered, provided industry cluster advantage for relevant enterprises. As a science park, it made available land, electricity, water, transportation, accommodation and educational facilities for investing enterprises. Hence, it satisfied almost all the infrastructure requirements of investors. More importantly, land, which was usually expensive and which the enterprise would prefer to rent rather than to buy, was offered for lease in the science park, which significantly reduced the investment cost.

However, one should keep in mind that the investment might expand in the very near future and the need for water, electricity, land, etc., will increase on a great scale following such expansion. Thus, a comprehensive and visionary plan must be developed before the establishment of the science park and must be amended from time to time. The relevant authorities should accept the application of investment based on the planned accommodation of the science park. In this way, science parks could be more efficiently and systematically utilized and be more responsive to the new needs of investors in the event of future expansion.

Cooperation between Central and Local Government

From the experience of Corning (Taiwan), it was apparent that the central authorities of Chinese Taipei were very service-oriented in helping resolve the difficulties investors faced. On the contrary, the local government to some extent failed to follow the policy of the central government and sometimes implemented measures that had adverse effect on the investment.

An example of the inconsistency of the policy between the central and local government was what occurred in the Central Taiwan Science Park. The establishment of the science park was determined by the central government and implemented with the assistance of the local government. Although urban planning was subject to its authority, the local government failed to consider the existing science park in making urban planning decisions. For instance, the Taichung City government had recently decided to permit a retirement home to be set up near the Central Taiwan Science Park. This in effect substantially raised the standards of noise and air pollution in the area. This kind of change was not expected by the investors and had resulted in an increase of cost on their part.

The success of investment depends on the support and assistance of the local and central government. To establish a friendly investment environment, the cooperation and communication between the local and central government is essential.

Painstaking Process but Fruitful Result on the Improvement of IP Protection

Though there seems to be complete and effective legislation and enforcement of IP laws in Chinese Taipei at present, the process of attaining this stage had not been easy in any way.

Chinese Taipei's vigorous legislation of IP laws in the 2000s was undertaken under great pressure from foreign governments and businesses, which urged Chinese Taipei to strengthen the protection of IP rights. Hence, a series of measures was undertaken by the authorities of Chinese Taipei in response to their demand. In addition to the significant amendment of IP laws, an IPR-specific task force was established to combat piracy. Regular training programs were provided to judges and prosecutors on IP rights matters. All these efforts were aimed to improve IP protection in Chinese Taipei in a short time.

However, the intensive and aggressive legislation accomplished in a short time was followed by protests initiated by different groups. When a negotiation conference or a legislative assembly regarding IP-related issues was held, drastic protests frequently took place in front of the Legislative Yuan, the Bureau of Foreign Trade and other government agencies. How to introduce the international standard on IP protection into the new legislation in a way that would accommodate the needs of domestic industry and society was the most difficult task for the legislators. Much was done to communicate with stakeholders and educate the public. Finally the appropriate bills were passed successfully.

Although the progress was painful, the outcome had been fruitful. The persistent attitude of Chinese Taipei authorities to establish a legal system for IP protection that was consistent with international standards had built up the confidence of investors in Chinese Taipei and successfully attracted foreign investment. But the story had not ended yet. With the development of technology, more and more new issues confronted the authorities of Chinese Taipei. Their continuous support towards the protection of IP rights would be essential to establishing a friendly and conductive environment for investment.

Conclusion

The investment process of Corning (Taiwan), though seemingly hydra-headed at first, ends with fruitful results. The four major challenges faced by Corning (Taiwan), namely, the protection of IP, infrastructure, consistency of legal environment and human resources, were resolved efficiently with the aid of both public and private sectors of Chinese Taipei.

Consistent communication among related stakeholders is a key factor in promoting investment inasmuch as investment is a continuous activity. There will always be emerging issues to be taken care of and there is always a possibility of investment expansion. With good communication, authorities are able to address the concerns and the needs of investors in a precise and timely manner. At the same time, the investors are able to understand better the investment area and are willing to make further investments. Differences are resolved gradually and the investment relationships are tightened up. The well-established communication channel between Corning (Taiwan) and the authorities of Chinese Taipei is expected to play an important role in the investment of Corning (Taiwan) in the future and make Chinese Taipei a more investment-friendly environment.

Shin Corporation (Thailand) and Temasek (Singapore)

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This case was developed based on the information that is in the public domain, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

Thailand had embarked on significant reforms in its investment regime. The investment liberalization initiative had been undertaken unilaterally. This was due to the recognition of the benefits of some degree of liberalization and competition in response to changes in the international economic climate. Thailand had to conform to the Agreement on Trade-Related Investment Measures (TRIMs) to eliminate trade-related performance requirements and investment barriers. Controls of Foreign Direct Investment (FDI) in the economy, however, remained quite extensive and complex. The policy instruments included restrictions on the entry and establishment of foreign investment and the level of foreign ownership permitted, special treatment of foreign investors, investment incentives such as tax and non-tax concessions, and operational restrictions such as local content requirements and minimum export levels that did not violate TRIMs. It was only recently that Thailand entered into various Free Trade Agreements (FTAs), which obviously prohibited the use of investment measures beyond TRIMs that had been generally used in other developing economies.

The Shin Corporation-Temasek case circumvented such restrictions and policy instruments. The transaction of selling the major shares of Shin Corporation by the Shinawatra and Damapong family to Temasek was done through several holding companies to circumvent the restriction of equity ratio in a Thai company by using nominees. The companies included Cypress Holdings, Kularb Kaew and Cedar Holdings. Cypress Holdings was a holding company of Temasek. It owned 49% of Kularb Kaew's equity but had 90% of voting rights. Kularb Kaew owned 41% of Cedar Holdings which held 54.5% of Shin Corporation's equity and also directly held 22.4% shares of Shin Corporation.[1] Thus, the main control of the company fell in the hands of Temasek, a foreign-owned company. The transaction also allowed tax evasion and circumvented the restricted sensitive area of industries prohibited to foreign investors.

This case study demonstrates that the lack of a transparent, rule-based investment regime and of a clearly articulated policy of progressive FDI liberalization might have contributed to illegal actions, uncertainty, ineffective implementation of existing investment laws and regulations, discouragement of good FDI, and harmful effects to the host economy.

Recommendations to the case include the strengthening of standard legal and institutional framework governing FDI's activities and the protection of FDI, enhancement of good governance and transparency, capacity building, ensuring fair competition, balanced liberalization and sustainable development, full participation of the host economy and local people, and standardization of labor laws and practices. All are essential to the liberalization and encouragement of FDI in Thailand that will result in a prosperous Thai economy.

Background and Introduction

Shin Corporation

Shinawatra Computer was founded in 1983 by Thaksin Shinawatra. The company grew to be one of the largest conglomerates in Thailand and changed its name to Shin Corporation in 1999. On 23 January 2006, 49.6% of the company's shares were sold by the Shinawatra family to Temasek Holdings, the Singapore sovereign wealth fund investment arm, for US$ 1.88 billion.[2] The sale turned out to be highly controversial in Thailand and contributed to the downfall of the Thaksin government.

The Shin Corporation group comprised Shin Satellite, Advance Info Services (the largest mobile phone network in the economy) and ITV, a local television station. It also held shares in Thai AirAsia, a low cost airline company. The operations of the Shin Corporation Group were divided into four business lines: wireless telecommunication, satellite and international business, media and advertising, and E-business and others.[3]

Temasek Holdings

Before 1974, the Ministry of Finance of Singapore held stakes in various local companies such as manufacturing and shipbuilding. With the incorporation of Temasek in 1974, the Ministry of Finance transferred all its stakes to Temasek but it continued to be the sole shareholder of the company up to the present. In 1981, the Ministry of Finance also set up the Government of Singapore Investment Corporation (GIC) which invested primarily the government's foreign reserves in assets outside of Singapore.[4]

In 2002, Ho Ching, the second wife of Lee Hsien Loong, who became the Prime Minister of Singapore, was appointed the executive director of Temasek Holdings.[5]

The Case of Shin Corporation and Temasek

On 12 January 2006, Kularb Kaew Co., Ltd was established in Thailand. Eight days later, the Thaksin government announced the new law on telecommunications, exempting from taxation the selling shares in a telecommunications business, removing the restriction on the equity held by foreigners,[6] and removing restrictions on the ratio of Thai nationals in the Board of Directors in a telecom company. Three days later, on 23 January 2006, the Shinawatra and Damapong families sold their 49.6% stake in Shin Corporation to Temasek Holdings for about 73 billion baht (about US$ 1.88 billion)[7] arousing considerable public suspicion about the deal.

The sale of Shin Corporation's shares by the Shinawatra family to Temasek was done through several holding companies, including Cypress Holdings, Kularb Kaew and Cedar Holdings. Cypress Holdings was a holding company of Temasek. It owned 49% of Kularb Kaew's equity but had 90% of voting rights. Kularb Kaew, on the other hand, owned 41% of Cedar Holdings which held 54.5% of Shin Corporation's equity. Kularb Kew also directly held 22.4% share of Shin Corporation.[8]

Officially, all these companies were regarded as Thai companies because Thai nationals held majority shares. But the Thai-held securities were issued the preferred shares, limiting Thai shareholders' voting rights to only 1%. Since Shin Corporation's four lines of businesses were all considered sensitive in nature, the public was concerned with the potential threats to national security due to the acquisition of the company's shares by Temasek.

Since Temasek was wholly owned by Singapore's Ministry of Finance, its transactions involving the take-over of local companies of other economies caused protests in those affected economies—including Thailand in this case—due to their close links to the Singapore government.[9]

The case involving Shin Corporation and Temasek had been investigated extensively on the grounds that the former Thai Prime Minister was guilty of corruption and tax evasion. It was a decisive factor in the subsequent *coup d'etat* and change of government in Thailand. But the case also pointed out issues with Thailand's foreign investment regime (which lacked a

rule-based policy framework) and its related laws and regulations, as well as its inefficient tax laws.

The Key Controversies

Thaksin Shinawatra was accused of selling out Thailand through the Shin Corporation-Temasek deal, which was prohibited under Thai laws because Shin Corporation's businesses were considered vital to the Thai economy. However, his supporters argued that the mobile phone industry was highly competitive, and that there were no criticisms hurled against its competitor, the Norwegian firm Telenor, when it acquired Total Access Communication, the second largest mobile phone operator in Thailand.[10]

Thaksin was also accused of restricting the Thai telecom sector to foreigners,[11] which made it possible for his own company to operate in an oligopolistic market. His supporters further argued that to avoid the conflict of interest, the former Prime Minister Thaksin needed to completely sell out his stakes in Shin Corporation.[12]

Use of Nominees

In acquiring Shin Corporation, various holding companies were used, including Kularb Kaew and Cedar Holdings. Kularb Kaew was owned by Thai nominees shareholders, Pong Sarasin, a son of the former Prime Minister, and his brother, Arsa Sarasin. Temasek was one of the owners of Cedar Holdings Company, which was also 10% owned by Siam Commercial Bank (SCB). The SCB which played an important role in advising and providing financial support to the deal had as its major stakeholder the CPB Capital Co., an investment arm of the Crown Property Bureau.[13]

Using local nominees by foreign owners was illegal. Critics deplored this method as a way of circumventing Thai laws and regulations restricting the equity ratio of foreign ownership of Thai companies. After the investigations, it was found out that Thai nominees held 24.1% of all shares in the Thai security market, and up to 30% of all shares in the technology sector. It was argued that the efforts to eliminate the use of nominees might potentially cause dramatic outflow of capital from Thailand. However, the investigation of the use of nominees was in progress and may result in legal reforms in the Thai economy.[14]

Temasek's Action

Temasek expressed its intention to reduce its shares in Shin Corporation. However, the Thai government continued to take legal action to further investigate whether Kularb Kaew was a nominee of Temasek.[15] Mom Rajawongse Tonhnoi Tongyai has replaced Pong Sarasin as the Chairman, who was removed from the Board of Directors. Mom Rajawongse Tongnoi Tongyai was said to be the private secretary of Crown Prince Maha Vajiralongkorn. The Crown Prince's office later declared that he was only a low ranking officer in the office.[16]

Problems and Challenges

The definition and interpretation of "nominee" under the Foreign Business Act of 1999, as well as the limitation of foreign investment in Thai companies may affect foreign investment in Thailand.[17]

The entry of foreign investors into the Thai economy. Thai laws and regulations on foreign investment restricted areas of Thailand's investment to foreign investors, but in practice these regulations were constrained by uncertainty on how to define a "Thai company." The legal framework governing foreign direct investment in Thailand consisted of national investment laws, administrative regulations and policies, investment-related laws and regulations, as well as bilateral investment agreements that were developed to ensure the protection and fair treatment of foreign investment.

The participation of foreign investors in the Thai economy was still subject to some restrictions and screening process under Thai laws and regulations.[18] It was accepted in international law that economies had sovereignty to screen and control foreign investment or even to expropriate foreign properties[19] if it was done for the public interest, based on the non-discrimination principle, with due procedure and fair compensation. Thus, the entry and establishment of foreign investors was generally left to the host economy's discretion.

The interaction of the three main players in an international investment, namely, the governments of the home and host economies and the transnational company (TNC), regularly encountered difficulties that resulted in conflicts that must be resolved. Problems included double taxation, repatriation of profit, expropriation, and compensation, employment of TNC staff, environmental protection, labor relations, technology transfer, group liabilities and directors liabilities, accountability, disclosure and anti-trust.

Thailand had embarked on significant voluntary reforms to its investment regime. The investment liberalization initiative was undertaken unilaterally,[20] recognizing the benefits of a degree of liberalization and competition as a response to changes in the international economic climate. By 1995, Thailand had to conform to the World Trade Organization's (WTO) Agreement on Trade-Related Investment Measures (TRIMs) to eliminate trade-related performance requirements. Controls of FDI in the economy, however, remained quite extensive and complex.[21] The policy instruments included the following:

- Restrictions on entry and establishment
- Restrictions on the level of foreign ownership permitted
- Special treatment of foreign investors
- Operational restrictions, such as local content requirements and minimum export levels that did not violate TRIMs, until recently, when Thailand entered into various FTAs, which obviously prohibited the use of investment measures beyond TRIMs
- Investment incentives, such as tax and non-tax concessions

Restrictions on the level of foreign ownership permitted. In Thailand, certain business activities were subject to the shareholding requirements stipulated in the Foreign Business Act. For companies engaged in production designed mainly for domestic consumption or distribution, Thai shareholding must not be less than 51% of the registered capital.[22] But export-oriented projects with at least 50% production allocated for export could be majority owned by non-Thais. If 80% or more of the output was exported, non-Thais could own 100% of the shares.

Restricted Areas of Industry to Foreign Investors

The Foreign Business Act of Thailand prohibited aliens from conducting certain types of businesses. The scheme of this law was to divide all prohibited businesses into three categories, A, B and C, as shown in the Appendix. Business activities in categories A and B were prohibited to aliens, while those in category C businesses were open to aliens provided

they obtained permits. In certain exceptional cases, the Director-General of the Department of Commercial Registration, Ministry of Commerce, might allow an alien to conduct a type of business that was classified under Category B, as long as the business obtained privileges from the Board of Investment (BOI).[23] For details, please see the Appendix.

Rationale behind the Ownership Restrictions

There were two broad policy objectives of these Thai ownership restrictions. The first was related to the economy's export-push policy. The rules encouraged foreign investors to invest in export-oriented industries in order to support the balance of payments. The Thai government was concerned about the importation of intermediate inputs and raw materials by foreign investors. But if the foreign-owned company intended to export a higher proportion of its product, this could be used to offset the importation of inputs. Therefore, the Thai government allowed a higher ratio of foreign equity in such a case.

The second broad objective was (as in other economies) to balance the economic interests of domestic and foreign investors, and to secure public order, health and the sensitive business sector. The Thai investment policy was actually influenced by "the trade-oriented investment pattern" which was complementary to the open regionalism that relied on market-driven factors more than on regulatory function. The interplay of domestic laws and regulations, bilateral investment treaties, economic policy, and more recently the commitments made by the host and home economies of FDI under the investment chapters of the bilateral FTAs all played an important role in the liberalization of FDI.

Sensitive Areas of Industry Prohibited to Foreign Investors

In addition to the limit set on the ratio of total equity that could be foreign-owned, there were areas of investment that were restricted and subjected to other major hindrances. For example, sensitive areas such as satellite, telecommunications, and media and advertising were under control. Nominees had been widely used to circumvent these laws, regulations and restrictions. There were even cases of individuals changing their nationality through marriage to a Thai national to qualify as an investor in Thailand.

The Telecommunications Business Act stipulated that the telecommunications business was prohibited to foreign investors. But the Thaksin government changed the law just one day before the Shin Corporation deal. Not only did the government eliminate the restriction but it also liberalized the process of granting licenses, even to business operators that did not own their own network for telecommunications services. This was stipulated as follows:

> **Section 7.** [24] *Any person who intends to operate a telecommunications business in accordance with the nature and categories prescribed in notification of the Commission under the law on the organizations to assign radio frequency spectrum and to regulate the sound broadcasting, television broadcasting and telecommunications services shall obtain a license from the Commission.*
>
> *There shall be three types of license as follows:*
>
> *(1) Type One License: being a license granted to the telecommunications business operator who operates without his or her own network for telecommunications services which are deemed appropriate to be fully liberalized. The Commission shall grant a license once notified by a person who intends to operate such business;*

(2) Type Two License: being a license granted to the telecommunications business operator who operates with or without his or her own network for telecommunications services intended for a limited group of people, or services with no significant impacts on free and fair competition or on public interest and consumers. The Commission shall grant a license once a person who intends to operate such business has completely fulfilled the standard criteria prescribed in advance in notification of the Commission;

(3) Type Three License: being a license granted to the telecommunications business operator who operates with his or her own network for telecommunications services intended for general public, or services which may cause a significant impact on free and fair competition or on public interest, or a service which requires special consumer protection. A person who intends to operate such business can commence the operation only after he or she is approved and granted a license by the Commission.

The rights of Type One, Type Two or Type Three licensee to operate telecommunications business in which nature, categories and scope of service shall be in accordance with notification prescribed by the Commission, which shall be in conformity with the nature of telecommunications business for each type of license under paragraph two. In issuing such notification, the Commission shall also have regard to the development of diverse telecommunications services and fairness among the operators.

The Shin Corporation (Thailand) and Temasek (Singapore) deal was subject to these regulations. Much of Shin Corporation's business was in activities that were prohibited to foreigners. Likewise, the equity ratio between the Thai and foreign shareholders which could not exceed the ratio of 51%:49% of the registered capital was circumvented through the use of nominees. The situation was further complicated by the opportunistic alteration of some laws and regulations that restricted foreign investment. These reforms were widely seen as supporting the deal and legitimizing the take-over of Shin Corporation.

Why Did the Deal Violate the Laws?

A review of Shin Corporation group's business structure and lines of business operation confirmed that the group ran many businesses that were prohibited to foreign investors in Thailand. These included telecommunications, airlines, and television stations.

On the other hand, in Thailand some businesses such as wireless telecommunications had been oligopolies that were run by powerful conglomerates, including Shin Corporation, which was one of the biggest conglomerates in Thailand. Hence, there was lack of competition resulting in ineffective business operations and service provision; limitation of consumer choice; high price combined with relatively low quality; and restricted network availability. Given this, a wiser approach to liberalization should have emphasized the strengthening of Thailand's competition law and policy.

The discretionary nature of tax administration was also problematic. Tax exemptions were granted on a case-to-case basis and were subject to alteration from time to time. The sale of Shin Corporation shares to Temasek Holdings was subjected to minimal public scrutiny regarding its tax implications, since the related laws were changed only one day before the deal was made. It was argued that the multiple sale of shares by the Shinawatra family was done to avail themselves of the opportunity not to pay taxes due to the new law promulgated

specifically for this transaction. It was also claimed that many loopholes were deliberately incorporated into the laws and regulations to monitor the tax collection system.

Nationality of Juristic Person

Another crucial issue in the Thai policy governing FDIs was how to determine the nationality of the company (i.e. the juristic person), given different underlying principles, including where the business was incorporated, where the business was managed, and who owned and exercised effective control.

There were three basic criteria to determine the nationality of a company or juridical person[25]:

1. *The concept of incorporation or constitution, according to which a company was deemed to be attached to the legal order under which it was incorporated, irrespective of the place and seat of its economic activities. This approach was preferred in the Anglo-American legal system. The rationale for this criterion was consistent with traditional international law.*[26]

2. *The concept of the seat (siege social or "headquarters"), according to which the actual management of a company determined its nationality. This concept had generally been followed in Germany and some other European economies.*

3. *The concept of control, according to which nationality was determined on the basis of the nationality of the shareholders who owned or controlled the company. This concept had been adopted by Switzerland and included in most of the recent Swiss treaties.*

In the Shin Corporation-Temasek case, the Thai government applied the corporate rule in conjunction with the equity ratio measure to determine the nationality of the juristic person. Any company that had been incorporated in Thailand and complied with the law that Thai shareholders must own the majority of the company or holding shares of at least 51% of the registered capital was deemed a Thai company. But given that nominees were widely used, as shown in the Temasek case, there was a loophole in the law. Even though the use of nominees was itself unlawful, it was widely practiced. As this case demonstrated, the company could manipulate the shareholding structure easily by issuing preferred shares to limit the voting rights of the majority of the shareholders. Consequently, effective management control and power were in the hands of foreign investors, not the major Thai shareholders.

The case suggests that Thailand should consider using the "control principle" to determine the nationality of the company. In the case at hand, since Shin Corporation was taken over by Temasek it was deemed to be a Singaporean company, because the effective control of the business resided in the Singaporean government through the Ministry of Finance.

Free and Fair Competition and Transparency

A further and perhaps more fundamental policy issue is whether such business activities should be considered sensitive to the Thai economy or not. In other words, should liberalization of foreign investment be seen as beneficial to the Thai economy by promoting competition or should specific business activities continue to be listed in a negative list that is closed to foreign investors?

Whatever restrictions remain should be transparent. That is, Thai investment laws and regulations need to be transparent, rule-based system and standard. Thus it would be beneficial both for the investor and the host economy if the Thai government were to standardize its investment regime and reduce the degree of discretion.

Addressing these Challenges

Potential areas of law reform include the following:

1. Implement an effective competition law and policy.
2. Further liberalize Thailand's foreign investment regime based on a clear, rule-based system.
3. Introduce a standard legal and institutional framework governing FDI's activities and the protection of FDI.
4. Clarify the principles and rules for determining the nationality of juristic person.
5. Standardize measures for environment protection.
6. Strengthen labor laws and regulations.
7. Promote good governance and transparency.
8. Standardize BITs and create an agreed set of investment rules.

In short, Thailand needs to create a favorable legal, political, social and economic environment for foreign investment. In order to continue attracting FDI, there must be a fair and liberalized rule-based investment regime in Thailand. This would both enhance the potential benefits of FDI for Thailand as the host economy and reduce uncertainty for the investor.

Conclusions and lessons learned

According to the accepted wisdom of neo-liberalism, the market is the most efficient allocator of resources. Therefore the market should be allowed to operate with as little interference as possible. Regulations should focus on protecting consumers, for example, through safety or environmental regulations, as opposed to directing the economy.

This leads to a preference for an open global economy with well defined rules but minimal barriers to the flow of capital or technology.[27] Foreign investment is regarded as an important source of capital, and FDI also brings to the host economies advanced technology, managerial skills, employment, and the improvement of production methods as well as competition that help to upgrade local firms' operations. This perspective entails an open market economy, even though firms still could be subject to some restrictions on the grounds of security, public order, health and other sensitive issues.

There are no comprehensive global investment regulations in today's world.[28] Rather, the BITs networks govern the transnational investment activities in conjunction with domestic investment laws and regulations. Standardization of BITs or creation of an agreed set of investment rules may solve the problem of FDI barriers.

Currently, the interplay of domestic laws and regulations, bilateral investment treaties, economic policy, and more recently commitments made by host and home economies in the investment chapters of the bilateral FTAs have all played an important role in the liberalization of FDI. These may form an agreed set of investment rules to facilitate and standardize the investment regime.

Such a system would help to discipline host economies, making it more difficult to introduce discretionary changes to laws or regulations on an ad hoc basis. Nonetheless, global investment liberalization must take into account legitimate domestic policy concerns including environmental protection, security, interest of public domain, public order, consumer health and safety and other issues.

The key lesson learned from the Shin Corporation-Temasek case was that the lack of a transparent, rule-based investment regime and a clearly articulated policy of progressive FDI liberalization might have contributed to illegal actions, uncertainty, and ineffective implementation of existing investment laws and regulations.

Endnotes

[1] Wikipedia, http://en.wikipedia.org/wiki/Shin_Corp

[2] *Ibid.*

[3] *Ibid.*

[4] Wikipedia, http://en.wikipedia.org/wiki/Temasek_Holdings

[5] *Ibid.*

[6] "Thailand's Thaksin Freeze Out," *Asia Sentinel,* 14 June 2007.

[7] The Shinawatra and Damapong families did not pay capital gains tax due to the special tax exemption. Although the tax exemption was legal, the sale drew heavy criticism over Thaksin's ethics on the grounds that Shin Corporation, a dominant player in Thailand's information technology sector, will be sold to an investment arm of the Government of Singapore.

[8] "Kularb Kaew has 1 year to cut non-Thai shareholding," *The Nation*, 10 January 2007, http://sg.news.yahoo.com/060223/1/3ywh2.html

[9] Wikipedia, http://en.wikipedia.org/wiki/Temasek_Holdings

[10] Wikipedia, http://en.wikipedia.org/wiki/Shin_Corp

[11] http://sanpaworn.vissaventure.com/log/237/abhisit-vejjajiva-economic-nationalist, and http://www.matichon.co.th/matichon/matichon_detail.php.

[12] http://www.ipsnews.org/interna.asp

[13] Wikipedia, http://en.wikipedia.org/wiki/Shin_Corp

[14] "Nominees likely to face more scrutiny," *Bangkok Post*, 26 August 2006.

[15] "Temasek may lose heavily on sale," *The Nation,* 18 October 2006.

[16] Wikipedia, http://en.wikipedia.org/wiki/Temasek_Holdings

[17] "Who can own what?" *Bangkok Post,* 23 November 2006.

[18] For example the Foreign Business Act B.E. 2542, Land Act, Telecommunication Business Act, Condominium Act, Investment Promotion Act etc.

[19] Schwarzenberger, G. (1969).

[20] Thailand gradually liberalized investment regulations step by step, aspect by aspect, and sector by sector without entering into any agreement for each liberalization at the time until recently.

[21] The analysis in this section was based on national investment laws of Thailand, compiled in *Doing Business in Asia.* Published by CCH Asia Limited.

[22] The required percentage of Thai interests in Thai-foreign joint ventures in agriculture, livestock, fisheries, mining and services used to be 60%, now it is reduced to 51% as other sectors produce for domestic consumption.

[23] Even though in theory an alien can ask for permission to engage in business listed in Category C, in practice permission is only feasible after the designated business activity obtains BOI privileges.

[24] Section 7 of the Telecommunication Business Act B.E. 2544 replacing the Telegraph and Telephone Act B.E. 2477 and the Telegraph and Telephone (no. 2) B.E. 2517.

[25] Adapted from Khettai Langkarpint, 1992 "Nationality of Juristic Person" abstract Bangkok: Chulalongkorn University.

[26] Because the corporation is a creature of domestic law and depends for its existence on domestic law, it can be destroyed at will by the domestic system that created it. For this reason, international law did not interfere with corporate personality in any significant manner. It was also logical that since the creation of the corporation depended on the will of the state as expressed in its domestic law, the corporation should have the nationality of the state in which it was created.

[27] Muchlinski (1995: 93).

[28] See Sornarajah (1994: chapter 6, p. 225-236) Also see Schwarzenberger, G. (1969: 109-20). Also see UNCTAD (1988:1).

Appendix: Areas of Business Restricted to Foreign Investment in Thailand

The restricted areas of investment not open to foreign investors were classified into three lists[*] as follows:

LIST ONE (Category A)

The businesses not permitted for aliens to operate due to special reasons:

(1) Newspaper business, radio broadcasting or **television station business**
(2) Rice farming, farming or gardening
(3) Animal farming
(4) Forestry and wood fabrication from natural forest
(5) Fishery for marine animals in Thai waters and within Thailand specific economic zones
(6) Extraction of Thai herbs
(7) Trading and auctioning Thai antiques or national historical objects
(8) Making or casting Buddha images and monk alms bowls
(9) Land trading

LIST TWO (Category B)

The businesses related to the national safety or security or affecting arts and culture, tradition, folk handicraft or natural resource and environment:

Group 1 - The businesses related to the national safety or security:

(1) Production, sale, repair and maintenance of:
   a. Firearms, ammunition, gun powder, explosives
   b. Accessories of firearms, ammunition, and explosive
   c. Armaments, ships, air-crafts or military vehicles
   d. Equipment or components, all categories of war materials
(2) Domestic land, waterway or air transportation, including **domestic airline business**

Group 2 - The businesses affecting arts and culture, traditional and folk handicraft:

(1) Trading antiques or art objects being Thai arts and handicraft
(2) Production of carved wood
(3) Silkworm farming, production of Thai silk yarn, weaving Thai silk or Thai silk pattern printing
(4) Production of Thai musical instruments
(5) Production of goldware, silverware, nielloware, bronzeware or lacquerware
(6) Production of crockery of Thai arts and culture

Group 3 - The businesses affecting natural resources or environment:

(1) Manufacturing sugar from sugarcane
(2) Salt farming, including underground salt
(3) Rock salt mining
(4) Mining, including rock blasting or crushing
(5) Wood fabrication for furniture and utensil production

LIST THREE (Category C)

The business which Thai nationals were not yet ready to complete with foreigners:

(1) Rice milling and flour production from rice and farm produce
(2) Fishery, specifically marine animal culture
(3) Forestry from forestation
(4) Production of plywood, veneer board, chipboard or hardboard
(5) Production of lime
(6) Accounting service business
(7) Legal service business
(8) Architecture service business
(9) Engineering service business

[*] Foreign Business Act B.E. 2542, Annex to the Act of the three lists.

(10) Construction, except for
   a. Construction rendering basic services to the public in public utilities or transport requiring special tools, machinery, technology or construction expertise having the foreigners' minimum capital of 500 million Baht or more
   b. Other categories of construction as prescribed by the ministerial regulations

(11) Broker or agent business, except:
   a. Being broker or agent for underwriting securities or services connected with future trading of commodities of financing instruments or securities
   b. Being broker or agent for trading or procuring goods or services necessary for production or rendering services amongst affiliated enterprises
   c. Being broker or agent for trading, purchasing or distributing or seeking both domestic and foreign markets for selling domestically manufactured or imported goods in the manner of international business operations having the foreigners' minimum capital of 100 million Baht or more
   d. Being broker or agent of other category as prescribed by the ministerial regulations

(12) Auction, except:
   a. Auction in the manner of international bidding not being the auction of antiques, historical artifacts or art objects which are Thai works of arts, handicraft or antiques or having the historical value
   b. Other categories of auction as prescribed by the ministerial regulations

(13) Internal trade connected with native products or produce not yet prohibited by law

(14) Retailing all categories of goods having the total minimum capital of less than 100 million Baht or having the minimum capital of each shop of less than 20 million Baht

(15) Wholesale of all categories of goods having minimum capital of each shop of less than one million Bath

(16) Advertising business

(17) Hotel business, except for hotel management service

(18) Guided tour

(19) Selling food or beverages

(20) Plan cultivation and propagation business

(21) Other categories of service business except that prescribed in the ministerial regulations

Logistic Facilitation for Investment Opportunity in Viet Nam and Lao PDR: A Pre-Feasibility Case Study

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This case was developed using information available in the public domain, solely for educational purposes as a contribution to the Project entitled "Capacity Building for Investment Liberalization and Facilitation" conducted under the auspices of the Asia-Pacific Economic Cooperation (APEC). The case is neither designed nor intended to illustrate the correct or incorrect management of the situation or issues contained in the case.

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Executive Summary

This case study illustrates an initiative made by a Thai company called Acutech Co., Ltd, a logistics services company. In 2007 the management of Acutech conducted a pre-feasibility study to consider options for relocating their customers' manufacturing factories from Thailand to Viet Nam and other neighboring economies, like Lao PDR and Cambodia.

A number of Thai companies were losing their competitiveness since the economic crisis in 1997. Many Thai companies found themselves under competitive pressures with the appreciation of the Thai baht. The Acutech group investigated the status of infrastructure within the facilities of the Danang Port in Viet Nam. It also conducted a survey of road transport facilities extending from Danang to the Lao Bao border town on the boundary of Viet Nam and Lao PDR. A similar survey of road transport infrastructure was conducted for the route to Suvannakhet, the Lao PDR border town adjacent to Mukdaharn, Thailand. Although Lao PDR had set in place an attractive investment promotion decree (Ref. No. 177/PM, dated 13th November 2003) to promote the Savant-Seno Special Economic Zone, most Thai investors did not regard Lao PDR as a prime location for investment for several reasons. Foremost among these was the difficulty of attracting high-quality labor force into the area that potential foreign investors had to contend with. For instance, a Korean company in Lao PDR, the Ko-Lao company, assembled motorcycles and passenger cars by hiring local labor.

The case study summarizes the key findings and recommendations of further assessing the investment opportunities which may exist in Viet Nam and its neighboring economies. A number of specific lessons learned have emerged from this analysis: First, firms have to diversify their business in order to cope with the rising cost of raw material supply and face fierce competition in a new business environment. Second, investment in economies where the level of development of physical infrastructures is inadequate can create opportunities for firms, if there is proper logistic arrangement. Third, relocation of Thai industries to neighboring economies is feasible if the logistics network could be managed and be cost effective.

Background and Profile of Acutech

This case study illustrates an initiative made by a Thai company called Acutech Co., Ltd, a logistics services company. In 2007, the management of Acutech conducted a pre-feasibility study to consider options for relocating their customers' manufacturing factories from Thailand to Viet Nam and other neighboring economies, like Lao PDR and Cambodia. A group of experts, including academics, were asked to join the team to study the prevailing conditions and experiences of other Thai companies in the region and to assess the investment opportunities and potential risks of locating in Lao PDR and Viet Nam. First, the group came up with a brief summary of the experiences of Thai firms investing in Viet Nam, and of another foreign company investing in Lao PDR. The group found that firms in these host economies were facing significant logistics problems in their supply chains. Acutech tried to design an integrated system for an investor in Lao PDR that would reduce the logistic costs of raw material inputs acquired from the Lam Chabang port and Bangkok spare parts suppliers. The company was also exploring a joint business venture with a Vietnamese logistics company in Danang to serve Vietnamese firms and take care of transporting their goods by land and sea transport.

In Ho Chi Minh City, officials of a Thai-affiliated company, the CP Viet Nam Livestock Co., Ltd who were interviewed regarding their experiences in Viet Nam, revealed that the CP group initially concentrated its efforts on the livestock business but would be interested to diversify into industrial estates management, urban food distribution and banking. Other senior officials from another feed stuff company, Betagro, who were also interviewed provided additional insights into their investment experiences in Viet Nam.

Business Rationale of Investment in Neighboring Economies

Thai companies had somewhat different business rationale for relocating to Lao PDR and to Viet Nam. Basically, a number of Thai companies lost their competitiveness since the economic crisis in 1997 which put many Thai companies under competitive pressures with the appreciation of the Thai baht. Many Thai companies were also affected both by rising wage costs and fuel costs. This was more evident in labor-intensive industries like garments and shoe manufacturing where Thai producers faced competition from emerging economies like China and Viet Nam. As a result, some factories shut down their operations.

The Thai government was very much aware of this situation. Partly in response to the competitiveness pressures, Thailand had been actively negotiating trade and investment promotion agreements with neighboring economies to secure sources of raw materials and create trade by exploiting the advantages of increased market size. In 2004, Thailand signed the BAGAN Declaration with Cambodia, Laos PDR, Myanmar and Viet Nam, to promote the growth strategy called Ayeyawady-Chao Praya-Mekhong Economic Cooperation Strategy (AMECS). The AMECS was intended to enhance economic competitiveness in the strategic areas, as well as facilitate the "relocation" of industries to border towns and neighboring economies so as to utilize cheaper supply of raw material inputs and labor for the labor intensive industries. The agreement was likewise expected to reduce the development gap among the participating economies, and curtail illegal labor movement across borders among strategic partners in the medium to long term. The AMECS Plan of Action proposed the creation of two so-called "economic corridors" within the Greater Mekong Sub-region (GMS): the East-West Economic Corridor and the Southern Economic Corridor. The East-West Economic Corridor linked Mawlamyine of Myanmar-Mae Sod to Mukkdahan of Thailand, Suvannakhet of Laos PDR and Dong Ha-Danang of Viet Nam. The Southern Economic Corridor linked Bangkok, Thailand with Phnom Penh, Cambodia and Ho Chi Minh and Vung Tau of Viet Nam. There were 384 common projects and bilateral projects under AMECS.

Thailand and Viet Nam were both APEC members who played vital roles in expediting economic activities along the major corridors. As of 2008, one of the projects in the pipeline under AMECS would promote the usage of Global Positioning System (GPS) and Radio Frequency Identification Tags System (RFID) technologies to facilitate truck and container transport among member economies, beginning with Laos PDR, Thailand and Viet Nam. The management of cargo and materials logistics using GPS information would help reduce bottlenecks within the transport system. It would also strengthen traffic planning and reduce both the time and the cost of cargo tracking by wireless mobile phone system. In addition, the RFID could provide real time verification of cargo. By using RFID tags, it would be possible to simplify the customs procedures of transshipments.

Based on the premise that investment in the neighboring economies might be hindered by insufficient trade facilitation, physically poor infrastructure, redundant documentary and bureaucratic procedures, and lack of human capital, the Acutech group investigated the

existing infrastructure within the facilities at Danang Port, Viet Nam. It also conducted a survey of road transport facilities extending from Danang to the Lao Bao border town on the boundary between Viet Nam and Lao PDR. A similar survey of road transport infrastructure was conducted for the route from Danang to Suvannakhet, the Lao PDR border town adjacent to Mukdaharn, Thailand.

Although the Thai government tried to promote investment of Thai companies in neighboring economies, the host economies gave preferential treatment to large investment projects from further afield such as Japan and Korea. Most Thai firms in general did not consider relocating and tapping cheaper material inputs and labor costs in Cambodia, Lao PDR, China and Viet Nam which could have been consistent with the spirit of AMECS. Rather than relocating their production base, labor intensive industries in Thailand addressed labor scarcity by employing guest workers from Myanmar and Lao PDR. But this was just a short term solution.

Lao PDR was not perceived by most Thai investors as a prime location for investment for several reasons. Although Laos had in place an attractive investment promotion decree (Ref. No. 177/PM, dated 13 November 2003) to promote the Savant-Seno Special Economic Zone, it was still difficult for potential investors to attract high-quality labor force into the area. Most people living in this predominantly rural region were in the traditional agricultural sector. Labor migration from rural areas to urban industrial estates came at a cost, as did skills formation. It was still unclear how the government, the investors and the workers themselves would share these costs.

During the course of its field survey, Acutech learned that in Suvannakhet a huge plot of land had been prepared for the construction of an industrial estate close to the Thai border town of Mukkadaharn. The Thaksin government (2005-2006) had planned to add Suvannakhet to Thailand’s domestic air transport network, which would have facilitated one-day round trip business travel to and from Bangkok thus lessening the time and cost of travelling. Such a development would encourage industrial relocation by Thai enterprises.

In contrast, following the completion of Viet Nam’s accession to the WTO, there had been a surge in industrial development both in the north around Hanoi and the Hai Fong area, and in the south in Ho Chi Minh and its suburbs. During its site survey, Acutech noted the construction of industrial estates and factories, as well as housing estates and new towns in the suburb of Ho Chi Minh City. A number of factories set up by global companies had also sprouted along the road to the Hanoi International Airport.

Overview of the Investment Experiences

Labor Market Situation in Viet Nam

Viet Nam had an abundant labor force of 40 million (composed mostly of young people aged less than 25 years old) and a literacy rate of 90%. Nonetheless, there was a serious mismatch between labor demand and supply, with Viet Nam having a surplus of unskilled labor and a shortage of skilled labor. Although the Vietnamese economy was growing rapidly, the labor market was characterized by a number of rigidities. The traditions of the planned economy in the past had resulted in a high degree of job security and a low turnover rate of only 4% as compared with the average norm in Thailand.

There was an official Viet Nam “minimum wage” which stood at US$ 50 per month in 2007, but actual compensation levels, including fringe benefits and overtime payments, typically exceeded this statutory rate. Undergraduate degree holders attracted starting monthly salaries double the rate of those without qualifications. The urban labor market was paid an 18-25% wage premium compared to its rural counterpart. State-owned enterprise employees enjoyed monthly incomes of US$ 90 while local private-company employees received US$ 50 and employees of foreign-owned enterprises earned US$ 131 as minimum pay. It was estimated that as of 2008, the cost of labor in Viet Nam, on average, was half that of Thailand.

CP Investment in Viet Nam. CP Viet Nam Livestock was established in Viet Nam in 1988 when the economy introduced “Doi moi” (renovation) as its path to new development. CP expanded into the CP Group of Companies consisting of separate livestock, seeds and packaging businesses as well as joint ventures in other fields such as banking. CP acquired and distributed local supplies of animal feeds like maize, tapioca chips, and rice barn that were sourced from the northern and central Viet Nam areas and from Lao PDR and Cambodia, using some 5,000 sub-contracting suppliers. Maize, tapioca root and rice barn were basic animal feeds, particularly for swine and chickens. The company’s main competitors were some American and Thai affiliated companies. The CP Viet Nam group tried to diversify its animal feed business into farming and food supply, seeds supply and fish feed supply businesses.

CP Viet Nam had 5,000 direct and indirect local employees who were working with 120 Thai nationals. Its policy was to employ as many locals as possible. It had 11 assistant vice-presidents, 50 general managers and 400 managers. While the CP pay structure was in the middle range, it reported some difficulties in attracting new work force to join the company recently because of the tightening of the labor market as a result of Viet Nam’s WTO accession. International as well as national companies were pushing the rates up for skilled labor, in particular those with modern management skills, especially accountants and finance specialists, computer specialist, and mechanical and civil engineers. The wage differentials between foreign and local firms were widening, especially for engineers, while the finance and banking industry were offering larger premiums for skilled labor.

To attract and retain talent, CP set up a program for education and information dissemination that promoted the company to local government officials. However, as the labor supply tightened, head hunting became more common as did job hopping in response to rising wages. CP found it necessary to redefine its recruitment policy to bid for new labor force as well.

CP had the reputation of paying on time and this reliability had been the source of security for its employees. The company provided allowances for food, transportation, and lodging equivalent to about 30% of the base pay. In compliance with government regulations to provide for social security to its employees, CP shouldered 15% and the employee paid 5% of the social security contributions.

CP also invested heavily in training. Throughout its long history, CP served as a learning institute for Vietnamese employees, who later left the company to set up their own businesses. This made possible the effective transfer of technology within the livestock industry.

CP executives reported that local Vietnamese authorities had been helpful and cooperative. Most of the regulations and rules governing procedures and actual implementation announced by the central government could be further discussed for clarification with local government officials and with local area representatives of the communist party. For its part,

the company also endeavored to support local authorities in their educational and cultural programs as part of its corporate social responsibility.

Despite its knowledge of the local scene and the presence of a highly cooperative environment, CP still encountered some fundamental drawbacks in procuring raw materials for animal feeds. Viet Nam had a complicated and inefficient procurement system between farmers and factories which added to the transaction cost of raw materials procured from local brokerage.

Betagro Investment Experience. Interviews with a manager of another feedstuff company—a subsidiary of the Betagro group of companies which had been a long time investor in South Viet Nam—revealed a different perspective. Although Viet Nam had acceded to WTO under the free trade regime, the economy still lacked foreign investor-friendly laws and regulations. New laws and regulations could be promulgated by local government at their will. Most laws and regulations seemed to give priority to Vietnamese firms in the hope that these firms would be able to catch up with international firms.

The animal feed business was unstable because of the increase in prices of raw material crops resulting from oil price increases. Farmers were increasingly turning to the production of “energy” crops for bio-diesel and ethanol production.

The company tried to import raw materials from Thailand via sea transport, which was cheaper than road transport via Savannakhet (Laos PDR) and Lao Bao (border town of Viet Nam-Laos PDR) to Danang for forwarding to Ho Chi Minh. Acutech was asked to help design a system to ship raw material inputs from Thailand via sea port to Betagro in Viet Nam. If this were to materialize, the logistics cost of raw material collection and delivery in Viet Nam might rise and might in turn lessen local firms’ competitiveness in the feedstuff business.

The experience of Betagro also confirmed that Viet Nam was in need of accountants, office personnel with English proficiency, and skillful technicians. It cost international firms US$ 250 a month to hire an accountant. Viet Nam was preparing to comply with its commitment to WTO that by 2009 foreign ownership of trading businesses would be allowed to reach 49% and that of agro-businesses could be 100%.

The tight demand for skilled labor had increased the cost for international firms; job hopping and changing work place had been more frequent than before the accession to WTO. In 2009, the situation may be more critical as the number of foreign firms in Viet Nam may dramatically increase.

In the case of raw materials, especially feed stuff, the investigation team found that it could be more cost competitive to ship finished animal feedstock from Lam Chabang Port, Thailand to Ho Chi Minh Port, instead of using locally procured raw material inputs. This was because the costs of, among others, local collection, logistics and cargo handling, warehousing and packaging in Viet Nam could be higher than the cost of imports and the interface with a logistics service provider.

The investment cases of CP Viet Nam Livestock and Betagro were special cases where there was close interaction between stakeholders wherein the investor like CP Livestock had a long-term relationship with the government of the host economy, owing to their decision to be the first group of companies to invest in Viet Nam long before the WTO accession. It was evident that the company’s success in the local marketplace relied on its favorable relationship with the local community, suppliers, customers and employees.

Overall the promotion of cross-border investment system had reached a more mature phase in Viet Nam than in either Cambodia or Lao PDR. A system to welcome foreign investors was in place, though this was still at the preliminary stage of implementation.

The Lao Bao Special Economic–Commercial Area, Quang Tri Province, Viet Nam and Savan Park Savannakhet, Lao PDR

On 12 January 2005, the Prime Minister of Viet Nam issued Decision 11/2005/QD-TTg in promulgation of the Regulation of the Lao Bao Special Economic-Commercial Area in Quang Tri province. Lao Bao SECA enjoyed greater economic incentives than other economic zones in Viet Nam because it was located in a remote border town. It occupied a total area of 15,804 hectares and contained a working population of 35,000. Like any other special economic zones, it provided major preferential policies as follows:

1. No value added taxes nor special consumption tax shall apply on both domestic and imported goods and services consumed in SECA.
2. No export and import tax shall apply for goods produced in Viet Nam and used in SECA for export.
3. Import taxes on imported materials shall be paid based on the imported materials constituting such products and goods.
4. Goods of Lao origin in SECA and imported into the domestic markets of Viet Nam shall be subject to a reduced import tax.
5. Projects investing in Lao Bao SECA shall be exempted from corporate income tax for four years and enjoy 50% reduction of payable corporate income tax for nine subsequent years; thereafter the tax rate of 10% shall apply, with losses being carried forward for tax purposes to subsequent years.
6. Investment projects shall be exempted from land rent for the first 11 years and enjoy a rate of 30% land rent applicable to Qung Tri's mountainous regions on the 12th year onwards.
7. People working in SECA shall enjoy a 50% deduction on taxable income.
8. Right-hand steering-wheeled land-road mechanized means of transport shall be allowed to go in and out of Lao Bao SECA to transport goods and passengers between SECA with Laos PDR and other neighboring economies.

A Korean company in Lao PDR. The Ko-Lao company, a 100% Korean-owned company in Savannakhet was established in 1997 with 580 employees in Vientiane and 648 employees in Savannakhet. The company assembled motorcycles and passenger cars by hiring local labor. Acutech helped manage custom procedure of the company's spare parts import from Korea through the Lam Chabang Port in Thailand. Specifically, Acutech provided cargo handling and road transport to ship spare parts to the Thailand-Lao PDR border at Mukkdahan and across the Friendship Bridge to Ko-Lao facility in Suvannakhet for unloading. The delivery time from the Thai port of entry to the factory was shortened to the fullest extent possible. It was an example of the investor and the host economy's central and local governments working together smoothly. Since there were few foreign companies in Savannakhet, there was no conflict between the local community and the foreign investor; in fact, Ko-Lao employed mainly local labor. Ko-Lao was also facing insufficient supply of skilled worker such as technicians and some other professionals with computer skills. Thus, there were many job opportunities for skilled labor in Savannakhet.

Ko-Lao's customers for both its passenger cars and motorcycles were local residents. The company tried to set up sales agents throughout Lao PDR for its products. The Laotian government recently granted banking licenses to privately owned investors. It was expected

that as the economy prospered, the extension of credit facilities to consumers would serve as the key financial instrument for the hire and purchase business.

Investment Opportunity of Logistics Service: A Case of Joint Venture Business between Acutech Co., Ltd and a Vietnamese Private Logistics Service Provider

The experiences of Thai firms investing in Viet Nam and a Korean firm investing in Lao PDR helped Acutech undertake an initial evaluation of the feasibility of entering into a business partnership with a Vietnamese private operator to provide logistics services. The potential partner was a private company with strong affiliations with the Danang Port of Viet Nam. Both sides agreed to collaborate by exchanging logistics services. The Port of Danang established a subsidiary company, SERVECO, to handle business matters. The president of this company was nominated from the Danang Port Authority.

Acutech had a memorandum of understanding with SERVECO and Danang Port. The two companies hoped to link cargo trucks by road transport from Danang to Bangkok via Laos PDR. This was in line with the spirit of the AMECS declaration on the East-West corridor. As of 2008, the business partnership has just been established. The partner companies were looking forward to implementing their plans as soon as the cost of shipment via the road system had normalized.

The volume of cargo via Danang Port at the Tien Sa terminal in 2007 increased by 25% from 37,400 TEUs in 2006. Danang Port Authority added an additional gantry crane at berth No. 5 at Tien Sa terminal. In addition, the Song Han (River) terminal would be transferred to a new site outside the Danang City area. It was expected that additional investment in facilities to improve the equipment handling system would materialize in 2010. The investment would cost US$ 70 million.

Container feeders that called at Danang Port at the Tien Sa terminal included MCC, Wanhai, Germartrans Samudera, Maga Star and ACL. Freight rates from Bangkok to Danang Port ranged from US$ 800-900 to US$ 1,450-1,600 for 20'x 40' size container. On the other hand, freight rate to Ho Chi Minh was US$ 260 to US$ 300-500, while it was US$ 600-700 to US$ 1,100-1,200 to Hai Phong.

The main commodities transported from Bangkok to Viet Nam consisted of motorcycle tires, materials for making shoes, tires, paper cone plus sugar cone woven fabric, air conditioners and polyurethane leather, and others. Around 90% was destined for the main ports like Ho Chi Minh and Hai Phong rather than for Danang Port. In order to increase the volume of shipment, Danang Port had signed friendship and cooperation agreements with Kawasaki Port (Japan) and Oakland Port (USA) as their sister port. It also negotiated with Chinese liners to increase the volume of shipment to and from East Asia. It might lower cost of shipping as well.

The average time for shipments from Danang to the border town of Lao Bao in Viet Nam was seven hours. It would take another seven hours for the shipments from Lao Bao to Savannakhet to reach the Friendship Gate between Thailand and Lao PDR. Thus, if a Thai company were to relocate to Savannakhet and take advantage of the General System of Preferential (GSP) provided for Laos products, it might not be cost competitive to export its products through Danang port.

The cargo handling fee was affected by the steep increase in gasoline prices. In addition, there was a lower frequency of call-of vessels per week at Danang port compared with the alternative of re-exporting via the Lam Chabang port in Thailand. Some 90% of shipment

from Thailand to Viet Nam was through Ho Chi Minh and the rest was through Hanoi. Moreover the possibility of a two-way shipment for cargo trucks between Viet Nam and Laos appeared quite limited, as fruits coming from China went through the northern border of Viet Nam and southwest China. The cost of fuel could be reduced if the trucks could shift from gasoline to NGV which might make the transport of cargo from northeast Thailand to Danang via Savannkhet more cost effective.

The situation at the Danang Port, Lao Bao SECA and Savannakhet might only be a constraint for the short-term, however. Another larger port in Danang was being constructed. When completed, Danang would become a more significant port of central Viet Nam. If Thai or other global companies were to invest in Savannakhet and Lao Bao or even in the Danang area itself, they might find the competitive situation changing rapidly.

In the case of Acutech, the final decision to enter into a joint venture business with the private logistics service provider in Danang was made by the chief executive officer and advisors who envisioned linking AMECS through the East-West corridor. The partnership with the Vietnamese private operator would help promote market access to Vietnamese logistics service. In return, the Vietnamese operator would be able to provide services for cargo shipment in Thailand through Acutech's logistics network. The two companies had a de facto business deal but had not yet formalized the agreement.

There were, however, risks and uncertainties that would challenge both Acutech and its Vietnamese counterpart once the relationship had been firmed up. Fuel cost had been rising which had made the proposed business model less feasible as far as road transport was concerned. From the beginning, Acutech was aware that an insufficient volume of two-way road transport cargo shipments could jeopardize the business model. Acutech tried to adjust its business strategy by asking the Vietnamese partner to handle its clients' cargo by road transport within Viet Nam.

Acutech focused on building a long-term relationship with its Vietnamese partner rather than simply concentrating on the potential of short-term profits. The adverse short term impacts of higher fuel costs could be overcome by fine-tuning the strategy without losing sight of the fundamentals. In fact, Acutech believed that the fine-tuning would strengthen the company's business strategy in the long run, since it would ultimately support the relocation of Thai industries to Viet Nam at Lao Bao/Danang and to Lao PDR at Suvannakhet. Once an integrated logistics solution involving cargo handling via both road and sea transport was in place, cost would be minimized, and increased investment through the relocation of both Thai and non-Thai companies could be expected.

Conclusions and Lessons Learned

Acutech assisted a non-Thai company to invest in one of Thailand's neighboring economies, demonstrating the feasibility of such cross-border investment for the company's production assembly. In the process, Acutech also learned that logistics is a significant constraint to further investment in the Mekong economies. Uncertainty regarding delivery time posed a significant risk to business operations.

Acutech thought that both risk and uncertainty could be reduced through the provision of well-designed logistics services to companies investing in these economies. In order to position itself as a provider of logistics services, Acutech tried to enter into a joint venture partnership with a private-sector Vietnamese operator in logistics services, the SERVECO, a private subsidiary of the Port Authority of Viet Nam in Danang located in the center of Viet

Nam. The volume of shipment through this port was not comparable with that of Ho Chi Minh port, but the Danang port planned to invest significantly in new facilities and link with China, Chinese Taipei and Japan. Thus, the port could be another gateway to East Asia for Thai products in the future.

Acutech planned to have joint land operation with SERVECO and cover Viet Nam, Lao PDR and Thailand as well as Cambodia. The partnership was not yet fully implemented since the required level of physical infrastructure was not yet in place in Lao PDR, Cambodia and Lao Bao and Danang in Viet Nam. Nonetheless, the initial study confirmed that the proposed joint venture was an appropriate strategy for the long term.

A number of specific lessons learned have emerged from this study:

1. Investment in economies where the level of physical infrastructures development is inadequate creates challenges and risks. Firms may be constrained in their production choices and may face a sub-optimal situation in managing their supply chains. In the case of Betagro, the company could not source raw material inputs at reasonable cost and acceptable delivery time. The company asked Acutech to solve this problem by shipping raw material inputs for its animal feed business directly to Viet Nam. Betagro later decided not to proceed with a planned investment in this business. CP Viet Nam faced a similar scenario with the rising costs of its raw material inputs, unstable market prices, and unacceptably high logistic cost for product delivery. CP Viet Nam, however, tried to minimize business risk by diversifying into the food business.

2. Investment in dynamic economies undergoing rapid transformation such as Viet Nam creates its own unique challenges. Firms contemplating such an investment must be prepared to re-evaluate their strategies continually in order to remain competitive. In Viet Nam, the completion of the WTO accession has led to fundamental changes in both the markets for raw materials and for final products. Without innovation in production technology or in marketing strategy, firms may not be able to adjust to the new competitive environment.

3. The case of international firms investing in Lao PDR has shown clearly that a well-conceived logistics service design can help firms solve problems of delivery time, reduce costs of maintaining inventories of parts, and effect cost reduction through the promotion of two-way traffic.

4. In order to achieve the economic potential of the relocation of industries from Thailand to neighbouring economies, it will be necessary to put in place a comprehensive *Agreement on Cross Border Logistics Service*s. This has not yet been achieved despite several rounds of negotiation.

Although the case situations examined related to particular circumstances in specific economies, the lessons learned have broader applicability to the GMS sub-region and to the APEC region as a whole. For example, trade facilitation including logistics is not fully developed between Thailand and Laos PDR and Viet Nam. The rising cost of fuel has become a serious constraint to road transport. Moreover, better facilities are vital to attracting investment in these economies. Even though Laos PDR is not an APEC member, this landlocked economy is important to potential investments within the GMS sub-region.

Similarly, the smooth transformation into a market economy that took place in Viet Nam also appeared feasible in Cambodia and Lao PDR. Indeed Cambodia had high potentials as an investment site. Already Cambodia was the site of several garment factories producing for the global market. It had also several prospects for plantation of cash crops and energy crops.