AN EVOLVING FRAMEWORK FOR OUTWARD INVESTMENT

A Chinese Approach to Conflict Sensitive Business

Dr. Jiang Heng

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About the Author

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Additional Credits for this Edition

In October 2013, the China Economic Publishing House published a Chinese version of this book. With the intentions to broadly share information to international actors about new approaches to conflict sensitive business being adopted in China, the American Friends Service Committee and CDA Collaborative Learning Projects jointly adapted Chapters 1, 2 and 3 of the Chinese version. Instead of simply translating the chapters, this edition reflects what we deem as relevant information for English-speaking audiences. The Preface and Chapter 4 of the English edition were written by staff of the East Asia Quaker International Affairs Program of the American Friends Service Committee in consultation with the author.

Portions of this book were compiled and edited by Ben Miller, CDA; Dost Bardouille, CDA; Kong Zhe, AFSC; Jason Tower, AFSC and Elizabeth Chey, AFSC.

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Content

Glossary of Key Acronyms

BIT	:	Bilateral Investment Treaties
CBRC	:	China Banking Regulatory Commission
CCP	:	Chinese Communist Party
CEO	:	Chief Executive Officer
CFO	:	Chief Financial Officer
CIF	:	China International Fund
CNOOC	:	China National Offshore Oil Corporation
CNPC	:	China National Petroleum Corporation
CSO	:	Civil Society Organization
CSR	:	Corporate Social Responsibility
CSRC	:	China Securities Regulatory Commission
EITI	:	Extractive Industries Transparency Initiative
EPFIs	:	Equator Principles Financial Institutions
EPs	:	Equator Principles
EXIM	:	Export-Import Bank of China
FCPA	:	Foreign Corrupt Practices Act
FDI	:	Foreign Direct Investment
GDP	:	Gross Domestic Product
IFC	:	International Finance Corporation
ILO	:	International Labor Organization
ISO	:	International Organization for Standardization
KIA	:	Kachin Independence Army
MIGA	:	Multilateral Investment Guarantee Agency
MOF	:	Ministry of Finance (China)
MOFCOM	:	Ministry of Commerce (China)
MNCs	:	Multi-National Corporations
NDRC	:	National Development and Reform Commission (China)
NGO	:	Non-Governmental Organization
OECD	:	Organization for Economic Cooperation and Development
OFDI	:	Outbound Foreign Direct Investment
PBC	:	People's Bank of China
PDAC	:	Prospectors and Developers Association of Canada
PSI	:	Principles for Social Investment
ROA	:	Return on Assets
SAFE	:	State Administration of Foreign Exchange
SASAC	:	State-Owned Assets Supervision and Administration Commission
SEC	:	U.S. Security and Exchange Commission
SOE	:	State-Owned Enterprise

Preface

This book represents a collaboration between Dr. Jiang Heng and other experts at the Beijing New Century Academy on Transnational Corporations (NATC), the American Friends Service Committee, and the CDA Collaborative Learning Project. The goal of the project is to help identify risks that Chinese corporate actors face in investing in conflict-affected nations, and to develop tools that Chinese actors might use to minimize these risks. The basic premise is that conducting a conflict impact assessment and applying conflict management tools in a systematic fashion will reduce conflict, and enhance long-term sustainability and profitability of investments. From the vantage point of the Chinese government, which is now in its 14th year of promoting the "going out strategy" encouraging outward investment, such tools will also function to enhance the reputations of Chinese companies, providing an important public good to the Chinese government and its enterprises.

This book consists of four chapters. The first three chapters were adapted from a Chinese version.[1] Chapter 1 reviews China's overseas investments in conflict-affected states and risks related to working in such regions. Chapter 2 draws lessons from three case studies of Chinese overseas investment projects, and introduces international best practices in conflict risk management. Chapter 3 introduces different frameworks that investors can use to manage conflict. A supplement, Chapter 4 offers non-Chinese readers a basic introduction to the history and governance structure of Chinese State-Owned Enterprises (SOEs), which represent over 80% of Chinese investment overseas.

This preface provides reflections on how this book might be used by different actors in their efforts to reduce conflict and strengthen cooperation with each other. The three most important actors are Chinese companies, the Chinese government, and Civil Society Organizations (CSOs).

1. How Staff of Chinese Companies Can Use this Book

This book can be used by all levels of company staff, from top executives to middle-level managers to field staff that work daily with local communities and deal with conflict risks.

[1] Note that the first three chapters of this book were adapted from the Chinese version, which was originally published as: Jiang, Heng, Out of the Mine Fields and Blind Areas of Overseas Investment Security: Conflict Risk Assessment and Management, China Economic Publishing House, Beijing, 2013.

For top executives, it is necessary for them to understand the problems and difficulties in overseas conflict management, and the significance of establishing proper institutions to carry out public communication, compliance policies and Corporate Social Responsibility (CSR) strategies. Chinese companies are well known for their centralized management style. Only when top executives realize the importance of conflict risk management can Chinese companies develop institutions accordingly. In Chapter 3, we list several key elements that a strong conflict management framework should include. This offers a starting point for decision-makers of companies to examine their existing institutions and practices, and make changes to improve them. In some cases, new institutions may need to be established.

Top executives make decisions, while middle-level managers carry them out. Improving or establishing new institutions inside a company requires a lot of work. The book includes some practices and experiences from different contexts around the world, but it does not provide a complete guide for managers to establish proper institutions. Middle managers still need to devote time to learning more about setting up institutions suitable for their own situations. Moreover, they also should find ways to recruit and train staff to build an effective team in dealing with conflict management.

For field staff, the book can be used to train teams in conducting a Conflict Risk Assessment and Management Plan, as well as developing skills of public relations and risk mitigation. The CDA Toolkit for Explorers and Developers, which is included in the appendix of the book, is a useful handbook, and should be studied by field staff. For staff working on non-exploration industries, the CDA Toolkit can serve as an important reference for developing tools for use in their respective sectors. Beyond learning the toolkit, field staff can learn and understand local cultures and customs not included in this book. Conflict management requires skills and knowledge, but it is ultimately founded on a sense of mutual understanding of each other.

2. Suggestions for the Chinese Government and Relevant Government Agencies

The Chinese government faces several challenges in advocating globalization of Chinese companies. As discussed in Chapter 4 of this book, so far many government agencies have started making policies, regulations and guidelines regarding overseas investment. Yet, deeper issues still need to be addressed. For example, some policies and guidelines are non-binding or unenforceable, such as the "*Guidelines on Environmental Protection for Overseas Investment and Cooperation,*" released in March 2013.

Another issue to examine is the difficulty of monitoring the conduct of medium-to-small private businesses overseas that operate in foreign countries. Unlike the large SOEs, which have strong links to the government, most small private enterprises do not bother to register with local Chinese embassies. The Chinese government should use more resources in host countries to monitor Chinese companies. For example, local Chinese Chambers of Commerce can serve as clearing houses for dialogue between companies and civil society, or provide services such as registration with embassies. Chinese embassies can ask CSOs to provide information about companies' compliance with social and environmental policies of Chinese national and local governments.

Admittedly, relationships with host governments can be a double-edged sword. Sometimes the Chinese government and companies become conduits for corruption by the host government. The Chinese government needs to be more cautious in these relationships, especially when it relates to transparency issues. Business information related to Chinese companies should be disclosed in accordance to international standards and practices to eliminate alleged accusations.

Beside policy makers, government agencies and think tanks also need to make more efforts in conflict management overseas. At present, no Chinese researchers can estimate the severity of environmental pollution caused by Chinese companies overseas because so far very few studies have been done. The statistics from government agencies is also incomplete because there is no systematic way to collect relevant data. These problems demand more cooperation from Chinese companies and CSOs in the collection of information and data.[2]

3. How Civil Society Organizations (CSOs) Can Better Engage Chinese Actors

The book identifies conflicts related to China's overseas investment. Tensions underlying such conflicts might be eased by strengthening corporate governance within Chinese companies, and local civil society can make a key contribution to this process. To achieve this goal, local CSOs should engage not only Chinese companies, but a wide range of Chinese actors, including government officials, academic circles, CSOs and media.

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[2] For reasons identified in chapter 5, this research focuses predominately on Chinese State Owned Enterprises. This does not mean to say that its findings do not apply to private enterprises or small and medium sized companies. This is a question that future research will need to consider in greater detail.

3.1. Political and Cultural Taboo in Engaging Chinese Actors

When local CSOs begin working with Chinese actors, especially Chinese government officials and companies, a cautious step-by-step process should be taken. Most Chinese entities are not familiar with international civil society in general, and some may have negative impressions about them. Before the reform and open policy in 1978, there were no CSOs in China and international CSOs were regarded as allies of western countries and potential threats to national security. Although domestic and international CSOs have been growing rapidly since 1978 (414,614 registered CSOs by 2009), the term "CSO" is still confusing to large segments of the Chinese public.[3] The Chinese media's approach to the unrest in Tibet in 2008 and the Arab Spring continue to cast a shadow on CSOs as being instigators. In fact, after the Chinese government began permitting western CSOs to operate in China in the early 1980s, it remained skeptical and suspicious of CSOs, associating them to the collapse of communism in Eastern Europe. Chinese and non-Chinese scholars alike made significant efforts to explain the role of CSOs to help the government develop a model of civil society suitable to the local context in Beijing.[4]

Collaborating with Chinese actors poses both opportunities and challenges for CSOs. Because of the sensitivity surrounding CSOs in China, more consideration should be taken in dealing with Chinese government actors and enterprises. Some practices, such as protesting in front of enterprises or government buildings are considered to be very offensive. Such actions, particularly when taken without any effort to consult with relevant Chinese companies, may end possibilities for dialogue or future cooperation. Moreover, it is important to keep in mind that if a government agency or an SOEs wants to communicate with CSOs, it may need to ask for approval from its supervising bodies before doing so. This process could take a significant amount of time, and could be undermined if CSOs take actions interpreted by Chinese authorities as "offensive" while they consider such requests. In Chinese culture, "face" is regarded as the most important part of personal dignity, so public efforts to embarrass companies could severely handicap efforts of Chinese CSR staff or company advisors to build dialogue or enhance relations with host communities.

[3] Ying Xu & Litao Zhao, China's Rapidly Growing Non-Governmental Organizations, 2010, http://www.eai.nus.edu.sg/BB514.pdf

[4] Caixia Chu, Grassroots CSO's in China: A Study of the Legitimation Process, 2011, http://hub.hku.hk/handle/10722/181512

3.2. Engage Chinese Companies

The best way for local CSOs to engage Chinese companies is to first offer help. For example, CSOs specializing in community development and peacebuilding work can offer training to Chinese companies, or even participate in the development of corporate conflict management tools. In the United States, CDA Collaborative Learning Projects is an example of one such organization. In Myanmar, which is also featured prominently in the book, peacebuilding organizations such as the Shalom Foundation or the Metta Development Foundation, or development networks such as Paung Ku might also potentially work with Chinese companies.

Development and implementation of CSR strategies is a key area where CSOs might collaborate with Chinese companies. Chinese companies face increasing pressure from the Chinese government to strengthen their CSR policies and implementation. Most enterprises only have preliminary knowledge about CSR and need help from CSOs especially overseas, where a key aspect of CSR is mitigating community impacts of projects. Many Chinese overseas investors have focused too exclusively on collaborating with the government in developing CSR programs, which in many contexts has caused them to fail in generating ownership on the part of community stakeholders. While such cooperation is still new for Chinese enterprises, CSOs might leverage this area to advance sustainable development programs and increase opportunities for local communities.

3.3. Engage Chinese Government Actors

Despite its suspicion of international CSOs, Chinese government actors are more open than many outsiders think in terms of allowing CSOs to take over some social services. For those CSOs involved in poverty reduction, natural disaster relief and education, governments at all levels are more hospitable, and in some cases, officials even provide help. Domestic CSOs understand the important relationship with government and leverage these relationships to present their concerns and realize their agenda on the ground.

The most powerful CSOs and companies in China are usually government-owned or -influenced, and they share the same values with the government. Because of such close connections, CSOs should regard partnership with Chinese embassies and organizations with government support, such as the local Chinese Chamber of Commerce, as the most important strategy in engaging Chinese actors. Embassies usually have a commercial counselor, the key person who represents the Ministry of Commerce and is responsible for supporting Chinese companies' investment and business activities. They understand Chinese corporate culture and have influence over the behavior of companies. Since they report to the Ministry regarding the status of China's investments, they may also contribute to policy development of overseas investment. The local Chinese Chamber of Commerce is usually under the supervision of the local embassy. Its major function is to connect with Chinese companies and consult with them on local issues. Contact with embassies may not be an easy task, given their suspicion of CSOs. It is suggested that if CSOs fail to make direct contact with embassies, they should try other indirect channels, such as Chamber of Commerce or authorities of the host country, rather than take to protesting or direct criticism. As mentioned before, it is a taboo in dealing with Chinese actors.

3.4. Engage Chinese Media – Constructive Journalism

It is also a regular practice for local CSOs to use the press to impose pressure on international companies. But for Chinese companies, the tactic usually does not deliver the expected result. For one thing, there is censorship in Chinese media and the Chinese public may not see the criticism of Chinese companies. Criticism from the press is similar to protesting, and does harm to relationships with Chinese companies. The press should be used rather to build relationships with Chinese governments and companies.

Some Chinese companies used to accept interviews from western media, but stopped because they always found themselves being criticized in the news.[5] Many of them have become suspicious of western media in general. In recent years, Chinese media also criticizes misconduct of Chinese companies, especially their domestic operations, but they have not been boycotted by Chinese companies. One possible explanation is perhaps that in Chinese media, Chinese companies can have their own voice and present their problems and difficulties.[6] The Chinese mindset stems on pragmatism, preferring to accept constructive solutions rather than mere criticism.

So instead of working with western media, CSOs could try to work with Chinese media, which has a better relationship with Chinese governments and companies. The Chinese press can bridge CSOs to Chinese leaders, encouraging leaders to listen to community concerns rather than viewing these concerns as attacks on Chinese enterprises. During recent years,

5 Hongxiang Huang, Oct 24, 2013, http://www.chinagoingout.org/2013/10/24/understanding-the-chinese-mindset-of-constructive-journalism-how-to-engage-chinese-stakeholders-as-china-goes-global/

6 Ibid.

due to scandals and other negative news about SOEs, the government seems very concerned about how public impressions can be shaped by the Chinese press. In new channels, such as social media platform, Weibo (China's version of Twitter), public relation departments of SOEs are drawing a lot of attention. Some state-owned banks require companies to address every customer's complaint on social media. One of China's most read Internet media, China-South Dialogue, actively reports many of China's overseas investment. CSOs can contact such media and ask them to help open dialogue with Chinese companies.

3.5. Engage Chinese CSOs

Along with Chinese enterprises, Chinese CSOs are also beginning to go global. Chinese government support has driven the growth of Chinese CSOs in Africa. According to current estimates, there are more than 100 Chinese non-governmental organization in Africa.[7] Although more and more Chinese CSOs are working in outside countries, the organizations have more learning to do as they face many challenges, such as lack of qualified CSO personnel, unfamiliarity with local languages, religions, social customs and so forth. These challenges provide opportunities for local CSOs to build relationship with Chinese CSOs. They can offer help in many ways such as training about local culture and community partnership. Since many Chinese CSOs have connections to Chinese governments and enterprises, collaboration with them can help local communities communicate their concerns more effectively to China's corporate and policy leaders. Chinese CSOs can also help local CSOs understand China's policies guiding Chinese enterprises operating internationally, and so improve the effectiveness of such policies on the ground.[8]

4. Conclusion

Working with Chinese actors is the first step in showing friendship and respect. Since China has been increasingly under criticism from CSOs during recent years, prejudice towards CSOs has led some Chinese to believe that CSOs are hostile towards the Chinese government and companies. A friendly gesture can help reduce suspicion of hostility and start building trust.

Traditional forms of advocacy, using aggressive tactics, such as public protests and press attacks by CSOs, usually fail to arrive at a long-term win-win situation with Chinese actors.

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7 China Daily, last modified Apr 26, 2013, http://africa.chinadaily.com.cn/weekly/2013-04/26/content_16452172.htm

8 Ibid.

Such tactics tend only to reinforce Chinese perceptions that CSOs are hostile towards China, which makes any form of dialogue more untenable. Instead of resisting Chinese companies, CSOs should develop more specialized roles to engage with Chinese companies. There have been some positive examples of collaboration between Chinese companies and CSOs. In Gabon, China National Cereals, Oils and Foodstuffs Corporation (COFCOT), a large national SOE, is working with the World Wildlife Foundation in sustainable forestry. In Ghana, efforts by the local Labor Union to build dialogue with one of the country's key employers, Sinohydro, helped promote improved relations between labor and management.[9] In Cambodia, the American Friends Service Committee, the Non-Governmental Organization (NGO) Forum and other local NGOs have initiated dialogue with the local Chinese Chamber of Commerce, with both sides exploring space to reduce community tensions and enhance sustainability around development projects.[10]

There is no doubt that China's overseas investment contributes to local economic development. There is also no doubt that during the development and investment process many problems emerge. Sometimes, China's role is demonized. But rejecting China's investment simply because it has some problems is similar to cutting one's head off to cure a headache. Even without China's investment, in the future there will be India, Brazil or other foreign investors, who may also be flawed. We hope this book can help different actors find a common ground to work together and overcome these challenges and difficulties in a constructive way.

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9 Ghana Business News, last modified 2013-05-17, http://www.ghanabusinessnews.com/2013/05/17/labour-practices-improve-at-bui-dam-site-report/

10 For news coverage of one of these activities see: "Chinese Chamber of Commerce Holds Conference on Investment Risk," Overseas Chinese Business Daily, January 23, 2014, http://www.jpzhs.com/portal.php?mod=view&aid=7646 (last accessed January 2015).

Chapter 1: Conflict Risks to China's Overseas Investment

In recent decades, overseas investment by Chinese State-Owned Enterprises (SOEs) and private companies has increased exponentially. From the late 1970s, China concentrated on attracting foreign investment to help restructure the Chinese economy. By the 1990s, this dramatically changed. The Chinese government began to actively encourage Chinese companies to invest abroad as part of its "going out" strategy. However, Chinese companies suffered substantial losses in conflict areas, such as in Libya. These losses have lead to a growing awareness in China about the need for better risk management of its investments. This chapter provides an overview of Chinese outward investments and discusses the reasons Chinese companies invest in conflict-affected nations, and the costs and risks that these investments face.

1.1. Current Situation of China's Overseas Investment

In 2011, China's outbound Foreign Direct Investment (FDI) reached a historical high of $74.65 billion USD, a year-on-year growth of 8.5%, continuing the growth of China's overseas FDI in the past decade.[11] By the end of 2011, more than 13,500 Chinese institutional investors had set up 18,000 overseas companies in 177 nations (including Hong Kong, Macau and Taiwan).

When reviewing the geographical distribution of nations that Chinese companies invest in, the author found that 80% of investments (or $61.23 billion USD in 2011) were made in developing nations in Southeast Asia and Africa. These nations, such as Myanmar, Pakistan, Sudan, the Democratic Republic of the Congo and Libya, all share the commonality of having large conflict-affected areas.

There is no single definition for the term "conflict-affected areas." According to the U.N. Global Compact, "conflict-affected" or "high-risk" areas are countries, areas or regions, which show evidence of one of four characteristics:

- High levels of armed violence is not currently present; political and social instability prevails; a number of factors are present that make a future outbreak of violence more likely.
- Serious concerns circulate about abuses of human rights, political and civil liberties, but violent conflict is not currently present.

[11] 2011 Statistic Bulletin of China's Outright Foreign Direct Investment, published jointly by the Ministry of Commerce, the National Bureau of Statistics and State Administration of Foreign Exchange.

- Currently experiencing violent conflict, including civil wars, armed insurrections, and other types of organized violence.
- Currently in transition from violent conflict to peace (These are sometimes referred to as "post-conflict." However, transition contexts remain highly volatile and at risk of falling back into violent conflict).[12]

These conflict-affected countries, areas or regions usually experience: human rights violations; the presence of an illegitimate or unrepresentative government; lack of equal economic and social opportunity; systematic discrimination against parts of the population; lack of political participation; and poor management of revenues (including from natural resources; endemic corruption; and chronic poverty).[13]

Conflict-affected nations often have low thresholds for entry by foreign investors, but these nations also have hidden risk factors. The political and physical insecurity in these countries pose great threats for companies. Complicated interest struggles and fierce competition for resources pose complex risks. In the early stage of investment, inexperienced investors are surprised by unusually high profit margins, but more often than not, they are soon faced with difficult problems. Once they realize the risks, it is often too late to withdraw their investment. Not only are investments in danger, but institutions and personnel are also threatened. The presence of investment in conflict-prone environments can also increase risks for local stakeholders. While the local context is inherently complex and risk-laden, it is the company's behavior and actions that play a large role in determining whether the company is able to succeed in this type of environment or fail.

1.2. Reasons for China's Investment in Conflict-Affected Nations

According to the author's research, Chinese companies have various reasons for investing in conflict-affected areas, ranging from their abundant natural resources to their strong government relations with China. Chinese companies also encounter challenges when trying to invest in mature markets.

12 Guidance on Responsible Business in Conflict-Affected and High -Risk Areas, United Nations Global Compact, Project Man agement and translator Meng Liu (China chief representative of Global Compact). Last modified Dec. 2013, http://www.unglobalcompact.org/docs/issues_doc/Peace_and_Business/Guidance_RB.pdf

13 Ibid.

The six main reasons are:

Abundant natural resources: Although conflict-affected nations are often characterized by an underdeveloped economy and corruption, these nations tend to enjoy abundant natural resources, which China lacks. At the same time, they are in need of massive infrastructure development, in which China has extensive experience. This can potentially create a win-win situation for both parties.

Government relationships: After the establishment of the People's Republic of China in 1949, China offered substantial economic aid to Africa, Latin America, and Southeast Asia for ideological reasons. China's interaction with these nations adheres to fundamental principles of China's foreign policy, especially the principle of non-interference in the internal affairs of other countries. As a result of these long standing ties, there are usually good relations between the foreign government and the Chinese government. Chinese companies, especially SOEs that have political ties with the Chinese government, value this and feel reassured by the good relations.

Low regulatory hurdles: Because they are in conflict, or recovering, many conflict- affected nations have less power and capacity to impose stringent regulation of foreign investment. Many Chinese investors are attracted by spaces with less or lower regulatory hurdles, as they often assume that this will translate into lower costs. Further adding to the problem is that many developing nations attempt to gain access to funds and technology they need for economic progress by giving highly preferential policies, which many not prove sustainable over the longer term. Nations in North Africa and Latin America have adopted preferential policies to attract investment that are similar to those that China adopted in its early stage of reform and opening-up. These policies include preferential tax treatment, construction of infrastructure and simplification of production processes.

Economic transformation of China: China has already reached a point in its development at which demand for new infrastructure and industrial production capacity have peaked. As the Chinese economy continues to shift, many infrastructure and manufacturing companies find themselves with large amounts of excess production capacity, and with the encouragement of the Chinese government, are looking for ways to utilize this capacity overseas. In contrast, most other developing nations are still in the early stages of industrialization. They are in need of technology, equipment and financial resources. At the same time, production costs, especially energy and resource demands, have been rising steadily in China in recent years. Therefore, China sees its industry structure as complementary to the needs of other developing nations in Asia and Africa.

Hedging price risks: Fluctuating and rising commodity prices in the global market are another reason why China's overseas investment focuses on natural resources. The annual growth rate of the world economy rose by 1% between 2003 and 2007, fueled, among others, by financial market and real estate bubbles in the United States. This economic growth led to the rapid and steady rise of commodity prices such as oil and iron ore. China attempts to hedge price risks by investing overseas, by entering resource and energy sellers' markets (which depend on the international market), by building strategic reserves, and by exerting greater influence on the global supply chain.

Less competition: Some enterprises deliberately choose to invest in these nations because many competitors are afraid of the high risks. As a result, enterprises that invest in high-risk countries face less competition and can earn higher profits.

Challenges of investing in mature markets: Chinese companies face difficulties in entering American and European markets, which are protected by a complex system of laws, regulations and import tariffs. This is particularly the case in the energy and resource sectors. Western politicians often harshly criticize Chinese business investors. They see China as a threat to local industries, and hold it responsible for the loss of domestic jobs and outsourcing of production. In China, this makes many people feel "the West" is biased against its rise. Chinese leaders perceive western businesses and leaders fearing China's competitive prices and protecting their monopoly over resource markets. In China, they say western countries have been able to profit from the international resource market for more than 100 years. As it's coined in Chinese, the "China Threat Theory," is a way in which western leaders pose China as a threat to western economies.

The case of China National Offshore Oil Corporation (CNOOC) can serve as an example. Its attempt to acquire Unocal Corporation in the United States was vetoed by the United States Congress in the name of "national security." As Chinese enterprises face huge difficulties entering American and European markets, they see high-risk nations in Asia, Africa, and Latin America as their only choice.

1.3. Risks of China's Overseas Investment

In the previous section, light was shed on reasons for China's investment in conflict-affected nations. Yet, recently Chinese researchers see a shift in Chinese investment analysis. Governments and businesses are seeing how investments in complex environments can be advantageous, but they also recognize the difficulty, and potentially more costly effects of investing in conflict-affected countries. These risks carry with them issues that complicate the initially high profits and returns. The risks are twofold. Some risks are caused by the nature of China's investment. Others are due to the risks inherent in investing in conflict-affected countries.

1.3.1. Risks Caused by the Nature of China's Overseas Investment

Sector-Specific Risks: From 2006-2011, energy, electricity, and extractive industries accounted for 75% of China's total overseas investment.[14] This type of investment exposes Chinese companies to higher risks than other investments would. Natural resources can be a root cause of conflicts in conflict-affected nations. According to the economic theory of the "resources curse," nations with abundant natural resources are often characterized by complicated interest conflicts and fierce competition for resources.[15] Investment in natural resources also has a profound impact on the environment and on local residents, and can therefore also contribute to conflicts. China's large investments in natural resources and the link between these resources and conflict make the investments of Chinese companies prone to high risks. Contributing to this risk is the fact that 47% of investments in the energy and electricity sectors are focused on large-scale engineering and construction projects.[16] Such projects have a large impact on local residents' lives and can lead to tension with the local population.

To deal with such risks, Chinese enterprises tend to copy their domestic experiences. However, these experiences often do not produce positive results abroad. Firstly, within China, these enterprises place an emphasis on their relations with the government, and manage relations with other stakeholders in that light. However, as further explained in the section on "lack of experience" below, associating with the government in conflict-affected

[14] According to Ministry of Commerce statistics for the 5-years leading up to 2011, of $215.9 billion USD overseas investment, nearly half of the money went into energy and electricity industry ($102.2 billion USD, 47%), followed by extractive industry, which attracted 28% of investment.

[15] The resource curse refers to the paradox that countries with an abundance of resources tend to have less economic growth, worse development outcomes and more conflict than countries with fewer natural resources.

[16] Ibid.

nations may increase the risks for companies rather than mitigate them. Additionally, social and environmental problems arising from poor production methods are not sufficiently dealt with in China. Often they are either not addressed by investors or the government has to step in to resolve problems. This replication of Chinese domestic behavior combined with a lack of action on the part of local governments means that the concerns and problems of the local communities are often not addressed. This leads to a deterioration of the relationship between the company and local communities.

Special Risks of SOEs: Doing business overseas is becoming an important source of revenue for state-owned enterprises. Most enterprises implementing the "going out" strategy are large and medium-sized state-owned enterprises, or ones in which the state is able to exert a high degree of influence.[17] These SOEs are more likely to take high risks as they are backed by the government and are sometimes more focused on sales revenue than on profitability. In the past decade, global sales revenue of Chinese infrastructure construction companies rose ten-fold from $5.4 billion to $50.6 billion USD, but their net profit margin continued to fluctuate at 2%, with some companies incurring substantial losses.[18]

Investment Models: Chinese companies are relatively new to investing overseas and some do not follow a cautious step-by-step approach to investment. A cautious approach to overseas investment could consist of starting exportation to a country, followed by franchising in the country, setting up joint ventures and as a last step becoming a wholly Chinese-owned company. In 2009, only 4.9% of overseas companies are set up as joint ventures, the rest are wholly Chinese owned.[19] This can result in companies lacking local knowledge on conflicts and other risks, as well as a lack of protection from local government in cases where conflicts emerge.

1.3.2. Risks Inherent in Investing in Conflict Affected Nations

Apart from the risks that stem from the nature of Chinese investments as identified above, nations affected by conflict and weak governance present a range of risks that are not present in China's domestic market or mature overseas markets. Differences in political,

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[17] Statistics show that by the end of 2010, China's non-financial foreign direct investment had amounted to $258.8 billion USD and total assets of overseas enterprises had exceeded $1 trillion USD. Investment from state-owned enterprises made up 50% of this figure.

[18] Data from Lubanway Consulting Firm. http://finance.jrj.com.cn/industry/2011/12/13170911821918.shtml

[19] 2009 Statistic Bulletin of China's Outbound Foreign Direct Investment.

legal and monetary systems are at play, but also cultural differences and the way in which the Chinese companies compete on the local market increases conflict risks. Chinese companies are often not aware of such risks upon entering a country.

Leadership transition in developing nations: In 2012, 59 nations experienced national leadership transitions. Developing nations without functioning democracy, stable institutions and market economy tend to see intensified conflicts and political instability during political leadership transitions. The probability of military unrest also increases during transition. During these periods, rapid increases in overseas direct and indirect investments in conflict-affected nations mean greater risks. In addition, political parties in these countries often do not cooperate well with each other due to long standing social differences. When a new government is elected, the political situation can change significantly. In some cases, a newly elected government may review all major contracts signed by former officials, resulting in cancellation or re-negotiation of many projects. However, investors in such cases often suffer the majority of losses.

Examples of this situation can be seen in Libya, Egypt and Sudan. When civil war broke out in Libya in 2011, Chinese companies were undertaking 50 major projects with a contract value of $18.8 billion USD in the country.[20] The investment mainly focused on infrastructure and telecommunications. However, due to the political unrest and work stoppage, Chinese enterprises suffered huge losses. This included the destruction of fixed assets and inventories, uncollectable disbursements, and settlement allowances for evacuated personnel. Mobs attacked 27 Chinese construction sites in Libya before they were evacuated, leading to the injury of Chinese workers. In January 2012, 29 Chinese workers were abducted in Sudan, and a few days later 25 Chinese workers were kidnapped in Egypt.[21] Both countries are going through a phase of political instability and governments cannot always guarantee the security of foreign companies and their personnel. The frequency and severity of these incidents raise fundamental questions about the risks to China's investment and workers' safety.

Economies of conflict-affected nations do not usually resemble mature market economies. When facing economic problems, these nations may resort to steps that are not aligned

[20] Sina News, 2011-04-07, http://finance.sina.com.cn/chanjing/sdbd/20110407/11449650985.shtml

[21] The workers were finally released on Feb 17, 2012 following extensive intervention by the Chinese government. The body of one worker killed in the attack was also turned over to the Chinese authorities.

with international best practices. A case in point is the mass privatization of Latin American nations in the 1980s and 1990s. Privatization was used to fuel rapid economic development in Latin American nations, but the extremely unfair distribution of wealth and social resources caused dissatisfaction among those not belonging to the elite. In 2000, this situation resulted in grave political crises in various countries. Left-wing parties came to power and abandoned privatization policies. Led by Venezuela, Latin American nations took strict steps of nationalization, and many foreign enterprises were forced to sell assets at a very low price or risk seizure by the government. Much of the capital investment could not be recovered.

Fiscal and monetary policies: Conflict-affected nations often have limited fiscal reserve. Their limited foreign currency and gold reserves mean that they are unable to keep price levels under control in times of economic crisis. This makes their currencies prone to substantial depreciation. The currency of Zimbabwe constitutes an extreme, if instructive, example. According to statistics from the central bank of Zimbabwe, the inflation rate was as high as 2,200,000% in 2008, making Zimbabwe the nation with the highest level of inflation on the planet. As the Zimbabwean dollar depreciated dramatically, the exchange rate of USD/ZWD jumped rapidly from 1:5300 to 1:120,000,000,000.[22] Obviously, such currency instability undermines a stable investment environment.

Cultural or religious differences: A lack of knowledge about local cultural or religious customs and beliefs can lead to friction and even conflict between Chinese businesses and the local population. Chinese companies are also often not aware of conflicts between different ethnic groups in a country. Examples of these situations can be found in Algeria and Myanmar. Unfamiliarity of Chinese workers with the Arabic culture led to fights between them and local businessmen in Algeria in August 2009, culminating in a mass fight in which several Chinese workers were injured.[23] In Myanmar, several Chinese workers were killed because they pointed at things with their feet, thereby breaching local religious customs.

Impact of competition on local markets: When compared to domestic enterprises in conflict-affected nations, Chinese enterprises enjoy lower production costs, advanced

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[22] Sina News, 2008-7-27, http://finance.sina.com.cn/world/ggjj/20080727/11275136083.shtml
[23] Sina News, 2009-8-5, http://news.sina.com.cn/c/2009-08-05/073918367991.shtml

technology, and well-trained workers. As more and more Chinese enterprises invest overseas, many local enterprises may be unable to compete with them in both domestic and foreign markets. This can result in local enterprises that compete with Chinese companies in the same industry, such as the textile or oil industry, going bankrupt. In addition, problems faced by conflict-affected nations during economic development may inspire feelings of resentment towards foreign competition. Local citizens may attribute economic problems such as high unemployment rates to foreigners, including Chinese workers, which may lead to conflicts, including boycotts, protests and even violence. For example, in some North African countries like Algeria, the high unemployment rate and better living standards of Chinese people have caused some locals to bear a grudge against Chinese nationals.

Security risks related to political and social polarization: The World Bank estimates that in Nigeria, 80% of $340 billion USD oil revenue goes into the pocket of 1% of the population, and the majority of Nigerian people are still living under the absolute poverty line. Polarization of social classes leads to social turmoil. The poor public security conditions in many countries lead to an inability of authorities to guarantee the security of foreign investors. Examples can be found in Nigeria and Colombia. Armed organizations have attacked petroleum companies and there are incidents of kidnapping of staff from time to time. Colombian rebel group Ejército de Liberación Nacional, or National Liberation Army (ELN) has blackmailed petroleum companies by threatening to bomb oil pipelines if they do not pay them money.

Difficulty to understand longstanding conflicts: Conflict risks can be difficult for a company to discern before an enterprise enters a new context. In the early stages of investment, investors may lack information about local conflicts, which impacts their ability to hedge risks and increases their vulnerability to conflict risks. In these conflict-affected areas, there is often a lack of communication between investors and local communities, making it harder for inexperienced investors to identify hidden conflict risks. As minor incidents accumulate, they may eventually lead to severe conflicts, giving the investor the impression that the onset of conflict is sudden and unpredictable. This poses serious challenges to the existence of projects and threatens the security of investing institutions and personnel. Persistent unrest in the Middle East and North Africa has made Chinese enterprises that invest heavily in engineering and construction realize the potentially severe risks involved.

1.3.3. Global Trends Affecting Conflict Risks

A number of global trends affecting local-level conflict make risk management of overseas investments even more complex.

The Global Financial Crisis: The global financial crisis has profoundly changed international politics and the regulatory environment. The crisis led to a worldwide economic depression and high inflation rates, affecting the lives of the underprivileged around the world but in particular in conflict-affected nations. In some countries this resulted in social unrest followed by political crisis. The political unrests in the Middle East and North Africa entailed huge losses for Chinese investors.

More Regions Involved in Conflicts: Nowadays, international unrest is not just triggered by conflicts among nations, but by internal conflicts within a nation developing into regional conflicts. The so-called "Arab Spring" spread throughout the Arab world. This was made possible because of similarities in the stage of development of these countries, connected economic structures, and relatively closed and fragile political, economic, and social models. In addition, modern information and Internet technology impacted the original equilibrium.

Changes to the Global System: Globalization causes in-depth change to the international system and many analysts predict a shift in power from Western to other countries (for example, the BRICS countries - Brazil, Russia, India, China and South Africa). Given the economic interdependence of large nations, this shift may not lead to military conflicts, but an increase in friction between countries is possible. Increasing competition may lead to conflict of interest over resources such as energy, including in the Polar Region, and may even extend to outer space one day.

Changes in Investment Regulations towards Protectionism and Social Responsibility: Due to the global financial crisis and European debt crisis, the world economy will undergo a prolonged period of slow growth and become more unpredictable and complex. Countries may wish to protect their economies more, leading to a growing trend for restrictive rules on foreign investment and a stricter review of foreign investment, thereby increasing the risk of protectionism. Civil Society Organizations (CSOs) and private enterprises have felt the effects of these changing policies when looking abroad for projects and companies to invest in. Host-country governments blocked cross-border acquisition attempts made by

Chinese enterprises, such as China National Petroleum Corporation, China Minmetals, China National Cereals, Oils and Foodstuffs Corporation and Huawei.

The "2011 World Investment Report" said that in 2010, 74 economies in the world implemented 149 investment policies.[24] About one-third of these policies set new limits or regulatory procedures for FDI. In addition to traditional trade protectionism policies, new trade protectionism policies such as carbon tariffs are emerging.

There is also an increase in non-binding social responsibility standards which affect FDI. The 2011 World Investment Report pointed out that in addition to some basic standards set by the International Labor Organization (ILO) and the Organization for Economic Co-operation and Development (OECD), different stakeholders are putting forward many more proposals in this field. This is relevant for Chinese enterprises, as the way they see their social responsibility at present contributes to their vulnerability to conflict risk.

[24] World Investment Report 2011, United Nations Conference on Trade and Development, http://www.unctad-docs.org/files/UNCTAD-WIR2011-Full-en.pdf

Chapter 2: Conflict Risk Management of China and Global Practices

After identifying risks associated with China's investment overseas, let's turn to several case studies and analyze reasons for failed investments. Internal flaws of existing risk management practices of Chinese enterprises and governments are identified. At the end of this chapter, international best practices are introduced as references for future reform in the risk management system in China.

2.1. Case Studies

2.1.1. The Myitsone Dam Project

In late September 2011, the new government of Myanmar suspended the Myitsone Dam project, claiming that the decision was necessary in order to respect the will of the people. As the number one investor in Myanmar, China has a large number of investment contracts still in progress, nearly all of which were signed with the Myanmar military government. In the face of the tremendous economic, political and diplomatic costs of the suspension of the Myitsone Dam project, no one in China was held responsible. Instead, the damages were seen as caused by "uncontrollable" external elements. Different explanations were put forward by different elements of society. Some argued that this was the result of an escalation of the conflict between internal armed groups and the central government, and a compromise on the part of the government. Others read it as the U.S. and other Western states applying political pressure on Myanmar in order to diminish China's influence. The investor, the China Power Investment Company placed several articles written by "Shuibo" on its official website that suggested a conspiracy. This noted that, on one hand, the Myanmar government had gone back on its word and the consideration of public opinion was an excuse. On the other hand, Western states and their Non-Governmental Organizations (NGOs) had played a critical role in this outcome.

The authors conducted a second field research visit to Myanmar in May 2012 and interviewed 400 people either individually or in focus group sessions. Their findings show that the suspension of the Myitsone Dam project had already taken on great symbolic value in Myanmar. Since then, the democratic revolution of the new government has changed things dramatically and the NGOs have been seizing the opportunity to promote democracy. The future stability of and operating environment for Chinese investment projects now face serious challenges, especially critical projects such as the Sino-Myanmar pipeline project, where environmental and social risks are a real concern in some areas.

The suspension of the Myitsone Dam project did not happen overnight. With the influence of a global wave of democratic movements, decades of aggregated ethnic, political and social conflicts in Myanmar exploded. This unleashed powerful forces pressing for democratic reforms.

Opposition to the Myitsone Dam project provided an engine to unite people within Myanmar and the international community. Rallying against the Myitsone Dam created a point of consensus within Kachin state, a complex state with deeply factionalized and politicized communities and allegiances. The Kachin Independence Army's (KIA) statements of opposition to the Myitsone Dam received universal support from the Kachin people. Even in Myitkyina, an area tightly controlled by the military government, the people opposed the dam. In the past, the Kachin had many different parties and factions, but now factions associated with the military government had been clearly marginalized. Past wars in Kachin state were limited to particular areas; the present war is taking place throughout the state in many places where there had not been fighting. During the Myitsone Dam controversy the KIA mounted an unprecedented resistance rarely seen in the decades of civil war throughout Myanmar.

Opposition to the dam also created a point of consensus along the Irrawaddy River. Not only did Kachin people support the KIA's opposition to the Myitsone Dam, but different ethnic groups living downstream were also sympathetic to the opposition. Nearly 60% of the population of Myanmar lives along the Irrawaddy River, and strong opposition to the dam united these people. The Myanmar government faces increasing difficulty maintaining its alliance with China, and instead may be looking to the West for support.

Opposition to the dam created a point of consensus with the international community. The suspension of the Myitsone Dam became a symbol of the goodwill of the Myanmar government. Even though U.S. President Barack Obama announced a policy of pivoting towards the Asia Pacific region at his inauguration in 2009, compared with France, the UK, Norway and other European Countries, the U.S, has been reluctant and conservative about engaging with politics in Myanmar. After the suspension of the Myitsone Dam, the U.S. shifted from a "wait and see" approach to taking action, raising the profile of reform factions within the Myanmar government, and sending a message that reforms can bring real benefits.

The conspiracy theory presented by Chinese editorials authored by "Shuibo" provoked greater anti-China sentiments and pro-America feelings in intellectual circles in Myanmar, and brought additional criticism from the international community. The reality is that many of these so-called “uncontrollable” and external factors were actually both preventable and controllable. If China and Chinese businesses continue to ignore the complexity of conflict-area issues, in the future, Chinese enterprises will face greater challenges from “uncontrollable” risks in Myanmar. Arguments, suggested by “Shuibo,” that support broad conspiracy theories, conceal the internal problems of how Chinese enterprises have operated.

One basic reason for the challenges that China has faced in Myanmar is the inadequacy of studies and lack of comprehensive understanding of the country’s complex dynamics. For several decades, Myanmar has been extremely strict with respect to the control of information and the media. As a result of long-term shortcomings of China’s area studies and the Myanmar government’s strict control over the flow of information, China’s research and understanding of Myanmar has always been extremely limited and biased. The situation is made more serious because some of China’s researchers behave more like bureaucrats than independent observers. Often they report only good news, brush aside deeper issue-based news, and attempt to flatter officials rather than tell the truth. This has further clouded China’s understandings of the situation in Myanmar. Through field studies, the authors found this problem to be extremely serious.

Over-reliance on high-level relations has also been a fundamental cause of the current problems. Working with high-level officials overseas has made China become over-confident and numb when it comes to perceiving the new social changes taking place in Myanmar. Chinese enterprises themselves tend to replicate their domestic behaviors when investing overseas, carefully following high-level exchange policies rather than following universally accepted international business practices of conducting risk assessments and implementing risk management of investment projects in high-conflict areas. Long-term ignorance of the societal level ultimately resulted in huge losses for Chinese investors.

Wishful thinking and failure to listen carefully to public opinion contributed to the investment’s failure. While China Power Investment Company insisted that the Myitsone Dam project was a win-win, it was unable to convince the Myanmar public. This is especially problematic given the high level of cultural sensitivity associated with the location of the project site, which has significant spiritual and cultural heritage value. Situating the location of the dam at the origin of the Irrawaddy River, a sacred place, could have appeared counterintuitive had the Chinese company investigated further beyond economic rationality. In a country where 90% of its population is Buddhist, economic gains may not play a leading role for local communities who value the spiritual and sacred aspects of the location. Also with sensitivities related to the destruction of the ecology and potential disasters resulting from earthquakes, it becomes harder to make a fully convincing argument in favor of the dam. Thus, when the tides began to turn towards reform in Myanmar, it is no surprise that this project, which never gained the support of the people, was the first to fall under attack.

Another reason is the limited awareness of enterprises with respect to non-market risks. Faced with sudden and unexpected losses, the investors expressed "extreme surprise."[25] Following a field visit in June 2011, the authors found that the Myitsone Dam project presented imminent political, social, environmental and cultural risks. The relevant enterprises were given two clear warnings by the research team, but neither were given sufficient attention, and three months later the project was suspended by the Myanmar government.

Finally, diplomatic negligence also contributed to the situation. Myanmar has historical foundations in democracy. From 1948 to 1962, it had a multi-party constitutional democracy and was the first Southeast Asian state to establish a parliament. Over the 26 years during which military rule replaced democracy, this country went from being the richest to the poorest in Southeast Asia. As the country stagnated economically, the desire of the people to return to democracy grew increasingly stronger. In the time of the global wave of democracy movements, Thein Sein and Aung San Suu Kyi jointly launched the democratic reform and opening to the outside world. Local experts say their joint efforts resemble the cooperation between the then ANC president Nelson Mandela and South Africa's former president Frederik Willem de Klerk. But in the Myanmar context, such alliances cannot succeed without the support of the military. Looking with hindsight, the military government showed signs of gradual change in its policies and practices, but China failed to foresee these changes.

2.1.2. Sino-Myanmar Oil and Gas Pipeline Project

Since the suspension of the $3.6 billion USD Myitsone Dam project in September 2011, the complicated situation has also created challenges for China's planned $2.54 billion USD

[25] Xingjiang News, 2011-10-05, http://news.xinhuanet.com/fortune/2011-10/05/c_122120911.htm

oil and gas pipeline project, which is seen by China as a potential major artery for resource flows into China. Some Myanmar political parties officially launched attacks on the pipeline project for the third time in July 2012, demanding the Myanmar government to review terms and possibly suspend the project for similar reasons cited in the Myitsone project. Political transition and military conflicts are major causes for investment delays, but during a field visit in May 2012, researchers found there are other problems with the Chinese enterprises involved, including the lack of Corporate Social Responsibly strategies, transparency and public relations.

Potential conflicts often exist in countries experiencing democratic transition. After political reform, many high level friends of China may lose their power, and the new governments may not be as friendly to China as their predecessors were. Previously important supporters of the project in Myanmar may no longer be influential. The most important supporter of the pipeline project in the Myanmar government was Vice President Tin Aung Myint Oo. In February 2012, he inspected and praised the pipeline project, which was interpreted by the Chinese media as support for the project. However, in less than three months, he resigned for health reasons. Yet many people in Myanmar think that he resigned under political pressure.

Public opinion has started to influence political decisions. Myanmar Energy Minister said in a recent interview: "I see every day on the Internet many groups raise the problems and the issues to disturb our project."[26] Expecting the project to be interrupted, foreign enterprises from other countries have started to withdraw from pipeline construction. In late March 2012, an Indian company withdrew from a 40 kilometer pipeline it took over from the China National Petroleum Corporation (CNPC) pipeline bureau. The company cited slow progress in the first segment of pipeline construction and the lack of operability as reasons for its withdrawal.

In addition to political transition, the military conflict between the government and KIA poses another risk to the project. On September 23rd, 2011, the Myanmar government attacked Shan areas where the KIA was stationed, claiming it was protecting the pipeline construction. As a result, in northern Myanmar, the construction has stopped. Battles between the government armies and the KIA have continued on and off for a decade, with

[26] http://uk.reuters.com/article/2012/02/14/uk-myanmar-china-idUKTRE81D03Y20120214

the most intense fighting occurring in areas where the pipeline is being constructed. At least 40 battles have occurred in this area. According to the local authority, the war is likely to continue for one to three years. The KIA is not only fighting a guerrilla war in the mountainous areas, but has also made statements that suggest they are shifting from a defensive strategy to an offensive one. The KIA has repeatedly and publicly indicated the possibility of attacking the pipeline. The assistant to Gun Maw, a senior leader of the KIA, openly said to the western media: "We do not want to damage the Sino-Myanmar pipeline now, but we are waiting for the response of China."[27] The KIA in the Shan Kachin areas once threatened it would take only one bullet to break the pipeline.

Globally, oil and gas pipeline projects are easy targets for attacks, and maintaining long-distance oil and gas pipelines is very difficult. Transnational oil giant Royal Dutch Shell is still troubled by this problem. Royal Dutch Shell was extracting oil in Nigeria in the 1950s when its pipelines were first attacked. Criminals have since broken the pipes and stolen oil from the pipelines, and there were sometimes as many as two explosions a month resulting in oil spillages and huge ecological compensation lawsuits. In 2008, this resulted in oil leaks of four thousand barrels, for which Shell had invested $2 billion USD into a recovery fund. Part of the Sino-Myanmar oil and gas pipeline will be above ground, and therefore, completely exposed, which poses an increased threat to future safety and security.

Civil society organizations like the Shwe Gas Movement (SGM) have openly stated: "This project does not share the benefits and interests with the local people, they just lose their property and livelihoods. Meanwhile, the project lacks transparency, financial accountability, and corporate responsibility."[28] The CNPC pipeline company has donated $4.07 million USD for social investment, which accounts for up to 10% of the total investment of the project.[29] However, social investment is not only about the amount of money invested, but also how the money is spent, and Chinese enterprises have little experience in CSR strategy.

Chinese enterprises also suffer from their inexperience in public relations. Myanmar's censorship laws had once been amongst the most rigorous in the world, but the number of

27 http://www.englishtang.com/view/89994.htm
28 Ying Hongwei, The Sino-Myanmar oil and gas pipeline project could become a chess piece, 2014, http://www.asienhaus.de/archiv/asienhaus/hintergrundinformationen/asienhaus-hintergrundinformationen3-2014.pdf
29 Social investment refers to voluntary, and sometimes legally mandated, financial contributions by companies in support of local community development. Principles for Social Investment (PSI), UN Global Compact, http://www.unglobalcompact.org/docs/issues_doc/development/PSI.pdf

private media outlets has increased rapidly. A new media law to be introduced in 2013 would change the role of the government from controller to promoter. Myanmar's Ministry of Information will be replaced by an independent, supervising institution. The end of censorship and increase in competition will bring dramatic changes, but this raises challenges for Chinese enterprises, which are generally not good at dealing with open and free media. The development of NGOs is continuing at high speed. A large number of international NGOs are rushing into Myanmar. Anti-pipeline organizations which were previously spread all over Myanmar are uniting together, and are cooperating with anti-dam organizations in the Irrawaddy River areas, with the aim of suspending the pipeline project. Most Chinese enterprises do not have experience with NGOs. The Chief Executive Officer (CEO) of China Power Investment Corporation told the press frankly after the suspension of the project: "We are not used to deal[ing] with NGOs."[30]

Moreover, transparency problems such as corruption, inequality and illegal behaviors exist in the process of community relocation for the pipeline project. Though Burmese staff lead the land acquisition and resettlement process for the project, mistakes and mishandling have been blamed on the Chinese company. For example, some villagers were forced to sign blank papers or they were not allowed to look at compensation contracts. In the Shartaw Village of Pwint Phyu County, some villagers organized door-to-door fund collections from their community, claiming the money would go to negotiating higher compensations for all. But, when it got out that some of those organizers received much more compensation than the other villagers, violence broke out, leaving one villager dead.

Other forms of corruption have also occurred in land measurement processes. Many villagers in different areas complained that their land was measured inappropriately, resulting in a significant loss in compensation for the actual size of their land. Some villagers said they suspect corrupt officials pocketed the difference in land compensations. Unequal standards in compensation were also obvious. Landowners with similar size lands received different compensation, with the inequality of compensations sometimes as high as 200%. During construction, there was a problem of temporary use of land beyond the scope of the planned area, sometimes exceeding 30% to 70% of the planned area. In cases where this happened, the villagers were not informed and farmland and forestland were often damaged. Many villagers, who already led difficult lives, became increasingly resentful.

[30] Xinhua Net, 2012-03-10, http://news.sohu.com/20120310/n337307799.shtml

2.1.3. The Angola Model

Angola used to be a beacon of China's Africa strategy. Knowing that Angola had no collateral or the ability to pay back loans, China cooperated with Angola in the form of buyer's credit. They agreed that Angola would pay back loans with oil from future extractions at Chinese developed oil wells. In this manner, the post-war reconstruction of Angola commenced, and this model came to be known as the "Angola Model." Although this was the favored approach of China in Angola, the World Bank issued a related report saying that: "exchanging resources for infrastructure" is nothing new in human exploitation history, and various other countries have entered into such agreements.[31]

The Angola Model was initiated by the oil loan framework agreement signed between China and Angola in 2004.[32] In the first few years, it mobilized the enthusiasm of Chinese enterprises and Angola leaders to the greatest extent, and the model was in line with the actual needs of both sides. China gained primary resources and energy needed for development, and near-exclusive access to the high-risk market. In return, Angola acquired urgently needed reconstruction funds and personnel when western countries were pulling out of the country.

The Angola Model relies on the support and agreement between the Chinese government and the local government. This model is an extension and development of the "strategy of broader-based foreign trade and economic cooperation" initiated by the Chinese government in 1994. This combines traditional aid and foreign economic cooperation, reduces the gap between the two, and uses loan policies to encourage investment in Angola. The Angola Model is based on mutual respect for state sovereignty and non-interference in each party's domestic affairs. With the support of the two governments, enterprises signed agreements on the basis of equality and mutual benefits. The enterprises then signed project specific agreements under the inter-governmental agreement framework. Angola uses its oil as collateral, and China imports the oil from Angola, offsetting the Angola's loan repayments required to pay for the construction conducted by Chinese enterprises.

Looking at the original purpose of its design, the Angola Model is in accordance with the interests of both China and Angola, and created a win-win framework. In fact, this model

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[31] Vivien Foster, et al., 2009, Building Bridge: China's growing role as infrastructure financier for sub-Saharan Africa, Washington DC: The World Bank.

[32] Ana Christina Alves, 2010, "The Oil Factor in Sino–Angolan Relations at the Start of the 21st Century," China in Africa Project.

has proved to be the most effective and has produced the highest short-term profits of all the Sino-Africa cooperation models, and has played a positive role in promoting the development of economic relations between China and Angola.[33] It has helped Angola to develop with Chinese funds and expertise. When western capital was withdrawn, China provided a timely injection of $4.5 billion USD in commercial loans, and then provided at least an additional $8.5 billion USD in infrastructure loans.

As for China, Angola's oil exports to China have become one of the most important sources of oil supply to China. The trade value between China and Angola has risen from $11.8 billion USD in 2006 to $24.8 billion USD in 2010. Chinese enterprises have participated extensively in infrastructure reconstruction projects including the Angola airport and harbor. In 2010, Chinese direct investment in Angola reached $0.35 billion USD. For example, Sinohydro Group took advantage of strong Sino-Angola cooperation to enter into the Angola market. Currently it has 958 Chinese employees in Angola, 170 project contracts, at a total value of approximately $3.45 billion USD, covering areas including hydropower engineering, municipal water supply, roads, airports, stadiums, city infrastructure, schools and hospitals in 17 provinces across Angola.[34]

In 2011, the vice president and chief economist of the Africa Development Bank, Mthuli Ncube said that China did not compete with traditional Western investors resulting in so-called "vicious competition," and did not cause problems for so many developing economies in Africa. Instead, African countries benefited from China's investment in infrastructure and technology.[35] Guinea has followed the Angola Model and the president of Guinea, Alpha Condé, said: "China is welcomed in African countries; we are very comfortable dealing with China; China is the opportunity of Africa, and Africa is the opportunity of China; President Dos Santos of Angola, President Jacob Zuma of South Africa, and Mali's president Toure hold the same view."[36]

However, as Angola's economy progressed through its post-war recovery with the help of Chinese enterprises, the country no longer had an urgent need for China's infrastructure

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33 Vines, Alex and Indira Campos, 2010: China and India in Angola. In: Fantu Cheru and Cyril Obi, eds. 2010. The Rise of China and India in Africa. London: Zed Books. p195

34 SinoHydro Official Website, last modified 2010-11-22, http://www.sinohydro.com/1096-2778-488169.aspx

35 Wu Xu and Li Xiajun, 2011-09-28, Africa corrects the misunderstanding of China's investment, China New Agency Beijing.

36 Zhang Lifen, 2011-09-16,China is not the neo-colonialism, Financial Times.

construction and became less enthusiastic about providing oil to China. As time passed and new situations emerged, the model encountered some specific challenges that need to be identified and addressed.

Firstly, the strategy of high-level exchanges increases the gap of different social classes in Angola. Angola is one of the world's most corrupt countries according to Transparency International's Corruption Index. In Angola, government officials can do business, own land, rent and sell land. The basis of implementing the Angola Model is the agreement between the two governments, so government officials often benefit before others. In some cases they take all the benefits in some areas, increasing the gap between the wealthy and the poor. On the one hand, Chinese investments caused profits for local government officials and their allies to increase rapidly. On the other hand, although infrastructure construction such as water supply, electricity and roads, has improved people's lives, the non-standardized implementation of the project and corruption created difficulties for local people. Local communities received inadequate compensation for relocation and construction left behind environmental destruction.

Secondly, compliance management in the areas of localization and corporate social responsibility are not yet in place, which results in community resentment. Under the permission of local governments, Chinese enterprises circumvent some legal requirements about localization and private investment. Under the impression of a good relationship with local governments, enterprises did not pay much attention to business risks or implement corporate social responsibility strategies. Some enterprises eager to have quick success, implemented loose quality controls, damaging the image of Chinese enterprises. In order to complete projects on time, some enterprises ignored local employment requirements, deeming local labor as not having enough capacity, and spent considerable amounts of money to bring Chinese workers to Angola. Reportedly, some 100,000 Chinese are now in the capital city, Luanda. Chinese workers and enterprises are often the target of organized crime networks in Angola. Anti-government armed forces also regard Chinese staff and facilities as targets. A sobering case is that of a Zhejiang businessman who was shot dead by locals in Luanda. The attackers left his expensive watch and other property intact, indicating the attackers' intent was not robbery. Negative public sentiment towards Chinese people is steadily spreading, especially when Chinese workers are blamed for Angola's high rates of unemployment. Violence may occur and threaten the safety and security of Chinese staff, institutions and projects.

Thirdly, appropriate communication and disclosure mechanisms are not yet in place. The Angolan president, who has been in power since 1979, directly controls Chinese loans through the national reconstruction office. Headed by his close allies, it has been accused of lacking transparency. The Angolan people do not have the ability to demand that its own government disclose information, leaving China the opportunity to share loan information, but such requests are often rejected. As a result, Chinese companies and governments are seen as legitimizing and empowering non-transparent and corrupt state entities in Angola. This is likely a greater source of anger among those seeking information, than China rejecting requests for information. It has given people reason to turn against Chinese enterprises.

Some social investments carried out by Chinese enterprises go unnoticed by the people of Angola, partly because not enough public relations work has been done to draw attention to the positive work. For example, China Tiesiju Civil Engineering Group observed a lack of drinking water in the local communities nearby their project. In 2011, it invested more than six million RMB to install a water purification device and establish a water purification factory.[37] The project positively increased the quality of water supplies for local residents. Such measures received praise from the local government, but few local people attributed the change to the Chinese enterprise. Many Angola farms, brick factories and other projects developed under the Xinjiang Production and Construction Corps and other enterprises, employed local hires at rates of 70%-90%, but most people in Angola still hold the belief that Chinese enterprises only hire Chinese workers.

Low transparency among Chinese enterprises has also allowed for misrepresentation. The Hong Kong Company, China International Fund (CIF) claimed to be "the shadow enterprise of the Chinese government" and misled local people for a long time. CIF won projects by paying large bribes to high-level officials. Upon hearing about this, China's Ministry of Foreign Affairs announced that CIF had no connections with the Chinese government, but it was unclear how these statements were received, since Chinese transparency in commercial and political activities had not improved. The negative impact of companies such as CIF is that Angolans still have lingering doubts, which have not yet been addressed, because channels for information have yet to be opened. This situation has affected diplomatic relations between China and Angola and has damaged the

[37] At the time of publishing the approximate exchange rate was $1 = ¥6.15 RMB

international image of China. Such instances require deep reflection, if Chinese authorities attempt to prevent such circumstances from happening again.

2.2. Lessons Drawn from Case Studies

There are many reasons why some of China's investments failed in the conflict-affected nations. These reasons include inadequate policy support from Chinese local and state governments, an incomplete risk management system within Chinese enterprises and inexperienced communication with the public and CSOs.

2.2.1. Inadequate Policy Support from Chinese Governments

At present, China does not have specific laws and regulations addressing conflict risks in overseas investment. Since 2009, the Ministry of Commerce released a document called, "Guidance on Investing in Foreign Nations." It provides information about political, economic and social conditions of host nations, but provides little guidance on how to manage conflict risks.[38] Regulations focus on company issues, such as foreign exchange earnings, tax payments and return on equity. This lack of protection for Chinese investing overseas is in contrast with the protection from political risks various laws give to foreign investors in China.

Apart from gaps in the law, there is also an issue of contracts. In China, contracts are often seen as a starting point of the relationship, rather than the end of negotiations. Therefore, Chinese companies tend not to pay much attention to the details in contracts. Given the extent of investment losses in conflict-affected nations such as Libya, Chinese companies need to ensure that contracts and agreements offer them better support in the event of loss caused by conflict. The Chinese government should consider offering legal assistance to companies investing overseas in formulating contracts in the future. For example, offering sample contracts can help improve clauses in investment contracts. As a precaution, Chinese investors with stronger negotiating power could include stability and compensation clauses in contracts, protecting assets if problems happen before projects are complete. In the meantime, force majeure clauses apply to unrest in host countries. Moreover, investment contracts should specifically point out how force majeure clauses exempt obligation to compensate, thereby making such clause more predictable and more stable. Investors should be entitled to compensation for losses incurred from social unrest in host countries through overseas investment insurance and mechanisms resolving investment conflicts.

[38] Ministry of Commerce, Guidance on Investing in Foreign Nations, 2012, http://fec.mofcom.gov.cn/gbzn/gobiezhinan.shtml

Of course, while contracts can certainly be improved, investing in conflict-affected nations remains a risk for investors. As conflicts often lead to a breakdown in the legal infrastructure of a country, it will likely be hard for investors to retrieve their money despite good contracts.

Beyond providing Chinese investors with domestic policy support, China also needs to reform its foreign policy. It is very difficult to initiate diplomatic protection mechanisms in times of social unrest and conflicts to protect overseas investment. Bilateral Investments Treaties (BIT) could play a role in the protection of Chinese overseas investment. BIT set the terms and conditions for private investment by nationals and companies of one state in another state, and also typically include issues such as protection from expropriation and full protection and security. Although China has signed 127 BIT since June 2011, most treaties were signed to protect foreign investors investing in China, rather than Chinese overseas investors. A large proportion of conflict-affected nations have not signed BITs with China. Other mechanisms for resolving investment disputes are currently absent or ineffective.

Since China's large-scale overseas investments are generally negotiated at a government-to-government level, China must adhere to the principle of "non-interference with other nations' domestic affairs" in managing crises related to these investments. In cases where a crisis involves a government's collapse, civil war, or other major social uprising, this generates serious obstacles for China in terms of initiating diplomatic procedures to protect investments. In reality, China's foreign affairs policy of "non-interference with other nations' domestic affairs" usually means supporting present political powers in conflict-affected nations. China's priority is to maintain stable bilateral relations, and to avoid getting involved in conflicts openly, unless critical national interests are threatened. If China abandons this principle and exerts pressure on conflict-affected nations to resolve conflicts, China's involvement can produce positive results. Western nations often link foreign aid with governments' performance against governance or human rights standards. This practice is often challenged when China provides an alternative source of finance and diplomatic support for countries with poor governance or bad human rights records. Because of their ties with governments with limited popular support, China suffers from damage to its reputation and investments.

Some foreign policies China adheres to today were formed during the Cold War. However, times have changed. At present, China's goal regarding international relations has shifted from Cold War thinking to Xiaoping Deng's saying that "Peace and development are the theme of the times."[39] At least, the term "domestic affairs" needs to be redefined. The non-intervention policy is often interpreted to mean that Chinese companies can only work with the host. This means that they cannot engage independently with the local population without involving the local government. This approach often leads to distrust within the local population. A rigid interpretation of "domestic affairs" makes investments in fragile and conflict-affected states more vulnerable.

Foreign aid also constitutes an important part of China's foreign policy. According to the white paper "China's Foreign Aid," China offers aid to most developing nations in Asia, Africa, Caribbean, Oceania and Eastern Europe, with Asia and Africa receiving 80% of China's international aid.[40] However, China's aid system is currently executed on a project-by-project basis, rather than as part of a broader coordinated policy. The Ministry of Commerce and the Ministry of Finance manage China's aid (there is no Chinese institution comparable to USAID), which is often provided in the form of package deals. Such deals combine commercial investment with aid components, for example a Chinese company will build a dam (commercial) and the Chinese government will support the building of roads (aid). China should understand that its interactions with these nations, whether in the form of investment or aid, have impacts on their internal conflicts. If it does not deal with conflicts carefully, foreign aid may aggravate tensions. Instead of providing aid to host governments, China can give aid through civil society organizations and directly to recipients within civil societies. These channels may ensure foreign aid reaches local communities rather than government officials.

Capital exporting countries can put into place an overseas investment insurance system (or overseas investment guarantee system) to remedy political risks to exported capital. Domestic insurance agencies will compensate investors for losses on investments due to political risks. This legal system in capital exporting nations aims at protecting and encouraging private overseas investment, and it is used globally to promote overseas investment.

In 2001, the State Council authorized China Export and Credit Insurance Corp to establish China's overseas investment insurance system. The system became operational in 2003. No commercial insurance companies have been allowed to set up similar systems. China

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[39] Deng Xiaoping, 1987, Report to Chinese Communist Party Congress.

[40] By the end of 2009, China had offered aid to a total of 161 nations and more than 30 international and regional organizations. 123 developing countries get frequent aid from China, including 30 in Asia, 51 in Africa, 18 in Latin America and Caribbean, 12 in Oceania, and 12 in Eastern Europe.

Export & Credit Insurance Corp mainly underwrites sovereign risk and consumer risk. Sovereign risk includes foreign exchange control, government expropriations, nationalizations and wars. Consumer risk includes buyers' credit risk (e.g. delay paying outstanding payments, default on outstanding payment, bankruptcy) and buyer's bank risk (risk from issuing bank or confirming bank). However, the scale and variety of insurance products cannot meet the needs, due to complicated applications processes, high insurance fees and a limited number of underwritten risks, etc.

Only 5.68% (or $17.3 billion USD) of China's overseas investment was covered by insurance in 2010. In Libya, only $400 million USD of the $40 billion USD in direct economic losses from the conflict were insured.[41]

2.2.2. Incomplete Research on Risks from Enterprises and the Civil Society

To invest in a conflict-affected nation, evaluating investment risks and establishing a sovereign rating system are needed. Chinese business actors would benefit from research and study of flaws in foreign investment policies and related political and social conflict risks. Thus far, little has been achieved in this regard. On the governmental level, the Export-Import Bank of China (EXIM) has studied a rating system and rating methodology for investee nations and has submitted a research report on this issue. However, the report is meant only to be applicable to the work of EXIM. Considering the government background of EXIM, the report cannot explicitly point out political and economic risks of other nations in the world, especially risks of developing nations. This would prove too politically sensitive for the leaders of these countries. The Chinese government has also published different reports[42] containing information about overseas investment, but these did not include a complete database on overseas investment risks. Consequently, enterprises investing in these areas have insufficient information and lack proper guidance, so they have no alternative but to copy domestic experiences. Their basis of understanding of stakeholders is limited to local governments and business partners. Some bureaucratic research institutes only report good news, concealing problems that have been discovered in practice. This may lead to more problems rather than helping to solve them.

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41 Sina News, 2011-4-11, http://finance.sina.com.cn/chanjing/sdbd/20110407/11449650985.shtml

42 "Foreign Market Access Report," "Catalogue of Countries and Industries for Guiding Investment Overseas," "Catalogue of Countries for Guiding Processing Trade." It also released "Guidelines on Investment Overseas" covering 162 countries (areas); implemented and revised "Statistical Investigation System of FDI," "Interim Measures for Joint Annual Inspection of Overseas Investment," "Measures for Overseas Investment Comprehensive Performance Evaluation (Trial);" "Interim Regulation on the Establishment of Chambers of Commerce (Associations) of Overseas Sino-funded Enterprises."

Relevant Chinese government departments could ask third-party institutions, institutions for higher learning, experts in civil society, or other third parties, to compile a conflict risks rating system and to publish reports periodically. At least with such reports, enterprises investing overseas can have research-based references. Third party institutions can also play a major role in building an overseas risk information system. At present, emerging civil rating and consulting agencies such as Sinotrust Management Company and Alliance PKU Management Group[43] do not offer such a system. These agencies confine their research to issues such as business internal management, marketing and capital operation. Their research ignores external political and economic risks – let alone complicated conflict risks.

At present, the Chinese evaluation system of overseas investment risk lacks a sound theoretical basis, an indicator system and quantitative analysis. When rating sovereign risks of investee nations, investors mainly rely on overseas rating agencies such as Fitch Group, Standard & Poor's, and Moody's. All three agencies have their own sovereign-risk rating tools and publish their rating results periodically. During the credit crisis, credibility of these three agencies was challenged worldwide because of their inadequate and sometimes incorrect rating results. According to a member of the European Central Bank's Executive Committee, rating agencies were even becoming a source of market volatility. However, as there are no alternative systems, nations and companies still rely on reports from these rating agencies.[44]

In particular, these overseas rating agencies do not have a sound rating system for developing nations and their rating methodologies for developing nations have inherent flaws. Agencies tend to perform technical analysis based on predetermined indicators that are more applicable to mature markets. Their ratings are flawed since they fail to properly consider special policies and different environments in developing nations.

By contrast, the conflict evaluation systems of multinational corporations tend to have very detailed and specific evaluation indicators designed especially towards investee nations. These companies have comprehensive and weighed requirements, stipulating how to operate evaluation systems. Their scientific evaluation system improves the accuracy of evaluation results, providing an evaluation system that Chinese risk rating agencies lack.

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[43] Others are e.g. Han Consulting, China Export and Credit Insurance Corp, China Council For International Investment Promotion,

[44] International Finance News, 2011-04-21, http://news.xinhuanet.com/fortune/2011-04/21/c_121331497.htm

2.2.3. Inexperience from Enterprises in Conflict Situation

Enterprises operating in conflict-affected areas can exert influence on conflict. The main reason that many Chinese enterprises experience frustrations in conflict-affected nations is that they have almost no experience and capacity to deal with local conflicts. A well-developed conflict management may include many parts such as sustainability, public relations, CSR, and government relations. Sustainable investment in cities and towns creates job opportunities, promotes economic development and recovery. An enterprise that incorporates CSR can improve human rights, labor rights, environmental protection and reduce corruption. Inclusive recruitment fosters friendship between local peoples and enterprises. By sustainable investment and CSR, an enterprise can earn a "social license" to operate with acceptance and support of local communities.[45] If an enterprise does not follow sustainable investment and CSR, it may intensify conflicts among groups, or become a target of conflicting groups. For example, enterprises may magnify social injustices, ignore concerns of local communities, breach environmental standards, strengthen corrupt political powers through bribery and non-transparent actions and support centralized political systems for their own interests.

As Chinese enterprises lack sufficient experience in global operations, they tend to copy domestic business models in conflict-affected areas.[46] They focus on building relations with senior government officials, and creating a "double-speed" economy in conflict-affected nations. On one hand, rich people and senior government officials benefit from the rapid development in the resources industry and local enterprises. On the other hand, specific issues such as resettlement affect the life of local residents, especially those who are most vulnerable to changes in environment and livelihood. Other enterprises that are inexperienced with resettlement compensation usually offer one-time compensation rather than providing training and alternative job opportunities to local residents, which can promote long-term stability. Their compensation policies dissatisfy local residents. In order to accelerate contract signing and project progress, some enterprises only try to please senior officials and lack communication with the local community. They do not seek the community's approval and they do not ensure the community knows what to expect from the project. Their operations are unclear to local residents, upsetting them and creating a greater risk of conflict between the company and community.

45 See http://socialicense.com
46 More information about domestic practices of Chinese enterprises is provided in Chapter 4.

Some enterprises cause damage to the environment and local residents' lives without compensation. Other enterprises pay attention to environmental protections and relations with local communities, but they only negotiate with governments about resettlement compensation, and do not involve other stakeholders, such as the public, NGOs, and the media. As governments in conflict-affected nations are often corrupt, and foreign companies are often allied with them, they are often charged with fuelling corruption. This leads to these companies incurring unnecessary losses through local opposition.

In order to improve the performance of Chinese companies' investments as part of China's "going out strategy," the gaps above should be addressed both by the Chinese government and by companies that invest in high-risk areas. Capacity can be built (within both Chinese governments and companies) by learning from international best practices in conflict risk management.

2.3. Global Practices in Managing Conflict Risk

China can both learn from and take advantage of existing knowledge, institutions, and international initiatives, rather than developing mechanisms from scratch to address risks. In this section, an overview of relevant practices of international institutions, national governments and multi-national companies is presented. The Chinese government and Chinese companies can make use of these examples to improve standards for their overseas investment system, especially with regard to risk management and to more effectively engaging local governments and communities and potentially lowering conflict risks.

2.3.1 International Institutions and Organizations

In recent years, growing risks in conflict-affected nations has drawn the attention of international organizations like the United Nations. Various organizations released guidelines on managing conflict risks and developed insurance against non-business risks. The so-called Extractive Industries Transparency Initiative (EITI), the Equator Principles and the requirements of underwriters can provide learning opportunities for China. As a minimum, Chinese companies should be aware of these mechanisms and their requirements for host countries, as they can impact investments locally.

Extractive Industries Transparency Initiative (EITI)

EITI was put forward in the World Summit on Sustainable Development held in September 2007. It became a milestone for the world resources industry in regards to sustainable development. EITI focuses on distribution of revenues brought by natural resources. EITI emphasizes that extractive companies should make public their payments to government, that there should be transparency over revenues used by those host country governments, and that an accountability system should be established. EITI's objective is to ensure that host countries and their people as a whole benefit from extractive industries. Host countries are encouraged to build evaluating indicators to promote sustainable development, so that related technical, theoretical and educational problems can be addressed.

EITI has won widespread support from the international community. Led by governments, the key to its success lies in the implementation. EITI principles and rules advocate active participation of CSOs. Government's leadership and companies' participation in this initiative is a promise to citizens and the international community to be more transparent and accountable in government management and business practices. Improving management skills can gradually prevent conflicts arising from oil, natural gas and extractive industries.

EITI is helpful in improving the investment environment, as governments make strides to increase transparency for investors, international financial institutions and their own citizens. For investors and international financial institutions, major benefits come from reduced political and reputational risks. Political instability resulting from lack of transparency certainly has a negative impact on investment. Payments to governments made by companies demonstrate that companies' investments contribute to society. Extractive industries are capital intensive and need long-term stable operations to recover initial investment, so reducing risks certainly promotes investments. For the public, it will have more trust in the government, and realize benefits from the company's presence, if it has access to information on how governments manage these revenues. Many countries, international oil and gas companies, and mining companies have already joined the EITI, but China has not joined yet. However, overseas Chinese companies have to consider whether host countries of their investments have joined the EITI.

Equator Principles

Major international financial institutions based on policies and guidelines set by International Finance Corporation (IFC) and World Bank established The Equator Principles (EPs). In October 2002, IFC and nine other banks including ABN AMRO held a meeting in London to discuss social and environmental issues in project finance. The outcome of this meeting resulted in a guideline on managing social and environmental risk in project finance. The guideline was based on the environmental and social policies of IFC, and became known as EPs. They have been revised based on the IFC's "Performance Standards."[47]

EPs have become a new standard in international project finance, as more than 40 large international banks including Citigroup, Standard Chartered and HSBC have adopted EPs, as have over 60 other financial institutions. They are known as Equator Principles Financial Institutions (EPFIs). EPFIs emphasize environmental and social responsibilities of enterprises when providing loans for projects. EPs list nine special terms and conditions that financial institutions should implement when making financing decisions. EPFIs are legally required by contracts to meet the standards. Other banks are not required to do so, but the EPs have become a good practice standard, making it difficult to obtain financing for projects that do not meet the standard. Since 2003, EPFIs have provided about 85% of the world's project finance capacity.[48]

In practice, EPFIs' primary responsibilities are to apply due diligence. Firstly, EPFIs need to review whether loans are used for project finance, since EPs are only concerned with project finance and not applicable to corporate finance. Secondly, EPFIs need to review whether the classification of risks is accurate. Different levels of risk trigger increasingly strict assessments and, at times, detailed risk mitigation plans before the project is approved. Thirdly, the EPFIs themselves must conduct audits of the projects to ensure that criteria are met and may not merely rely on materials and experts provided by the sponsors. Although EPs are based on the environmental and social policies of IFC and World Bank, EPFIs cannot exercise recourse rights on World Bank and IFC. Therefore, even if EPFIs, World Bank and IFC are lenders to the same project, they each have to apply due diligence. The Equator Principles are slowly gaining ground in China, and at least one Chinese bank (Industrial Bank) adopted the EPs in 2008 and is using them in practice.

Multilateral Investment Guarantee Agency

The Multilateral Investment Guarantee Agency (MIGA), a member of the World Bank Group, offers insurance against non-commercial risks to member countries. MIGA has more than 150 member countries and China is a major sponsoring country. The preface of its

[47] http://www.ifc.org/wps/wcm/connect/115482804a0255db96fbffd1a5d13d27/PS_English_2012_Full-Document.pdf?MOD=AJPERES

[48] Equator Principle Official Website, http://www.equator-principles.com/index.php/in-the-media?start=70

"Environmental and Social Review Procedures" clearly points out that it is MIGA's policy that all the projects guaranteed by MIGA must be undertaken in an environmentally and socially responsible way. Therefore, all projects guaranteed by MIGA must abide by the MIGA Environmental Assessment and Disclosure Policy. The MIGA environment office is responsible for reviewing, discontinuing, and monitoring investment projects according to the "Environmental and Social Review Procedures."

MIGA sponsored projects are required to be compatible with environmental and social security policies regarding natural habitats, forests, controlling pesticides, dam safety, non-voluntary immigration, indigenous people, preserving cultural heritage and international waterway projects. For Category A (significant pollution) projects, the "Environmental and Social Review Procedures" states that investors have an obligation to consult and to disclose. To consult means to consult affected citizens and local interest groups about environmental damages. To disclose means investors must properly disclose their impact on the environment and the Environmental Assessment Report. Even if host countries approve a project, MIGA still needs to ensure that investors have consulted with and fully disclosed information to local communities. For Category A projects, MIGA will conduct an on-site review.

The Procedures also provide a detailed list of factors that investors need to consider when planning and undertaking projects. MIGA sponsored projects have to abide by environmental regulations of host countries and by guidelines of MIGA, whichever are stricter. If there are no applicable regulations in host nations or environmental guidelines from the World Bank, MIGA can even apply other internationally recognized environmental standards or best management practices to a project. MIGA may also give investors suggestions to make sure they abide by MIGA environmental policies. Therefore, investors who apply for insurance have to make clear in on-going statements that they will take actions to ensure consistent adherence to environmental rules during the term of insurance contracts.

2.3.2. National Experiences

Apart from the international frameworks and institutions as identified above, China can also learn from experiences in other countries. After World War II, most capital exporting nations in the world drafted and implemented risk mitigation plans. These plans provide insurance for their nations' multi-national corporations against political risks in host countries. These risks may arise from government expropriation, nationalization, civil unrest or restrictions on outflow of foreign capital. Many nations offer diplomatic protection to private investment by signing bilateral or multilateral agreements and relying on international economic organizations. Many developed nations also use their international influence to exert political and economic pressure on developing nations. Different legislations in different countries result in different legal systems in protecting overseas investment. American or Japanese insurance systems are typical examples. The differences between them are explained below.

The United States

The U.S. was the first country that adopted an overseas investment insurance system. In April 1948, it formulated the Economic Cooperation Act based on the Foreign Assistance Act and created a new agency, the United States Agency for International Cooperation, to manage foreign assistance affairs (i.e. overseas investment). This was the start of an overseas investment insurance system.

In 1969, Congress revised the Economic Cooperation Act and set up the "Overseas Private Investment Corporation" and placed it under their direct leadership. The Overseas Private Investment Corporation became an agency specialized in guaranteeing American overseas investment. The guarantee has a condition that the capital importing nations must sign a multilateral investment guarantee agreement, so America's investment insurance system can be called a multilateral system. As the system effectively protects overseas investment security and interests of the capital-exporting nation, many other nations including Japan, Germany and France, followed the example of the U.S., and established domestic overseas investment insurance systems. However, these multilateral guarantees and insurance options do not actually guarantee the investment against business risk or against some kinds of non-business risk, but rather against certain political risks such as nationalization. The system has not always been undisputed. Certain forms of investment guarantee have created very difficult and sensitive political issues between the U.S. and the countries in which it does business.

On behalf of the U.S. government, the Overseas Private Investment Corporation has signed multilateral investment guarantee agreements with more than 100 countries. In the meantime, an insurance company has the right of subrogation, which means that after an insurance company pays indemnity for losses due to insured political risks, it can claim the cost from host countries. When the large-scale economic reform in Latin America took place at the beginning of the 21st century, it tested the effectiveness of the Overseas Private

Investment Corporation. Many American enterprises such as Exxon, Mobil, and General Motors were nationalized and received no or minimal compensation. The Overseas Private Investment Corporation actively took international legal action. The Corporation sent a team of more than a hundred experts to Argentina and Venezuela and conducted heated negotiations with local governments. In the end, the Corporation managed to protect part of American companies' overseas investment interests.

Japan

Japan implemented an overseas investment insurance system in 1956. The system evolved from Japan's export and credit insurance system. According to Japan's 1956 "Trade and Investment Insurance Act," Japan's overseas investment insurance system was classified into two categories: "overseas investment insurance on invested capital" and "overseas investment insurance on profits." In order to enrich the investment insurance system, the Japanese government combined the two categories in May 1970. The Japanese insurance system features "a unilateral system," which means protection given does not depend on multilateral agreements with host countries. Any Japanese investors and legal persons can apply for insurances for their overseas investment.

Among developed nations, Japan is most active in encouraging multi-national corporations to invest directly overseas. At least eight agencies are involved in providing consulting services concerning Foreign Direct Investment (FDI), and most of them are associated with development assistance. For example, Japanese enterprises can benefit from the "Overseas Technicians Training System" in training their overseas employees. The system allows enterprises to trust the Association for Overseas Technical Scholarship to train overseas employees, and a certain percentage of government funds are provided. If corporations want to send a team to conduct overseas investigations, they can apply for government assistance via the "Overseas Investigation Assistance System."

Another institution is the overseas investment research institute set up by EX-IM Bank of Japan. The institute is an information center focused on providing information to Japanese companies with overseas investment and on promoting overseas investment activities. It provides information, consulting and operation services to companies. Services cover not only investigating the feasibility of potential projects, planning constructions and implementing process, but also providing the latest and reliable market information and details of sales and distribution channels for products.

Japan lays emphasis on utilizing government advantages in providing information services in conflict-affected areas, and it establishes relevant agencies responsible for it. For instance, Japan Bank for International Cooperation (JBIC) annually provides analyses of the current situation as well as future trends in foreign direct investment. JBIC provides valuable information, guides and assists FDI activity, and offers technical assistance.

2.3.3. Multi-National Corporations

Some Multi-National Corporations (MNCs) from developed nations have been working in conflict-affected nations for many decades, so they are more experienced in risk management than Chinese companies are. MNCs tend to have fully fledged risk management systems, and assess risks on an on-going basis, not only before starting a project. Chinese enterprises can use MNCs experiences to improve their businesses practices in such countries.

The risk management mechanism of multinational corporations requires companies to fully consider and evaluate impacts on stakeholders in conflict-affected nations, especially the impacts on communities. For on-going projects, the mechanism also requires consistent monitoring of conflict risks and establishing an early warning system. Leading international resources companies, such as BHP Billiton and British Petroleum, are highly concerned about conflict risks and interests of local communities. They believe that investment in natural resources has a long-time horizon that may exceed the term of current government officials, so it is unreliable to depend only on current leaders. Before they make a final investment decision for potential projects, they usually spend a whole year researching local communities and evaluating conflicts. Their investment decisions are based on research findings.

Investment decisions can only be made after concluding that risk conflicts can be kept under control and risk management plans are feasible. Principles of risk management plans include: 1) Conduct all business activities in accordance with code of staff conducts. 2) Comply with international and local laws and customs, and avoid corruption such as bribery when interacting with local governments. 3) Build cooperative relationships with NGOs and local organizations; 4) Implement CSR strategies to bring benefits to local residents; 5) Try to achieve a win-win situation with local communities rather than only with local governments or a few groups.

When multinational corporations invest in conflict-affected countries, they emphasize monitoring conflict risks on an on-going basis. They continuously update relevant databases and evaluate conflict risks in a timely manner. Conflict-risk management ideas are reflected in daily operations of multinational corporations and these corporations continuously implement innovative policies in managing risks. For instance, some American and British resource companies recently introduced a "local community shareholding" plan. At least 1% of shares of undeveloped mining resources projects are given to nearby residents for free. Dividends are allocated annually to a special "local community investment fund" that is managed jointly by investment professionals employed by corporations and residents' representatives. The fund invests in low-risk projects to make sure that the fund maintains and increases value. After the project development is over, corporations will completely exit the management and investment of the fund, so the fund is under complete control by local residents. This plan fundamentally aligns the interests of corporations and local residents, and is very effective.

2.3.4. Preventing Conflict in Exploration: A Toolkit for Explorers and Developers

The Toolkit is developed collaboratively by the Prospectors and Developers Association of Canada (PDAC), World Vision Canada, and the Corporate Engagement Program - CDA Collaborative Learning Projects, and supported by the Department of Foreign Affairs and International Trade – Canada. The Toolkit is intended as a simple and practical guide, providing key steps for preventing conflict through constructive community engagement in exploration. The Toolkit draws from the tools of the collaborating partners, including the Corporate Engagement Program Framework, PDAC's e3Plus and World Vision's Making Sense of Turbulent Contexts. The Toolkit also draws its content from a series of field tests with exploration companies as well as the input of many contributors and collaborators. Their contributions are acknowledged therein. The complete Toolkit is included in the appendix of this book as a reference.

Concluding Remarks

There is a clear need for improvement of risk management systems of Chinese companies that invest in conflict-affected nations. The Chinese government also has a role to play in this respect, especially in setting guidelines, building information systems and addressing regulatory and diplomatic protection gaps. Chinese companies need to realize how their practices can influence local conflicts and even make them a direct or by-proxy target. The examples of Myanmar, Libya and other countries have shown that the odds at stake for Chinese companies are in excess of several billion US dollars, which currently can hardly be retrieved.

While investing in conflict-affected nations is more risky than investing in mature markets, a company's ability to do proper risk analysis and implement conflict risk management can reduce losses if conflict breaks out. Making adjustments to corporate behaviors that may be influencing conflict can save companies significant time, energy and money before situations reach irreversible consequences. Such conflict risk management systems adhere to a number of basic principles of conflict risks management and are put in a specific framework, which will be elaborated on in Chapter 3.

Chapter 3: Conflict Management Framework for Overseas Investments

Rapid development of overseas investment requires a stable global investment environment. However, after the financial crisis, the turbulence of the global political situation has escalated. Some developing countries, in which Chinese enterprises made large investments because of China's geopolitical advantages, are becoming high-risk investment countries. The structure of Chinese overseas investment means they are susceptible to becoming involved in conflict, and due to the major blind spots of conflict risk management, it is very important for Chinese enterprises to establish a scientific and systematic conflict management strategy framework as soon as possible. No shortcuts are available when it comes to conflict risk management. But certain models exist which can inform Chinese enterprises.

First of all, the authors collected and analyzed a number of relevant international guidelines, including the Guidance on Responsible Business in Conflict-Affected and High-Risk Areas issued by the UN Global Compact ("UNGC guidance"), OECD's Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas and its Gold Supplement, CDA/Corporate Engagement Program's Preventing Conflict in Exploration ("CDA guide"), Stakeholder Engagement: A Good Practice Handbook for Companies Doing Business in Emerging Markets by the International Finance Corporation, the Essential Guide to Implementing the Kimberley Process by the World Diamond Council, the Extractive Industries Transparency Initiative and the Equator Principles.

Secondly, references are made to the internal risk management structures and institutions of transnational companies. Western transnational companies, which in some case have been active in conflict-affected areas for over one hundred years, have learnt their lessons and gained much experience in the area. The authors have conducted field research focusing on the risk management experiences and internal compliance control in more than thirty companies including BHP Billiton, Anglo American, Alcoa, Siemens, ArcelorMittal, Intel, Motorola, ABB, Shell, PWC, Ernst & Young, GE, BASF, Pfizer, Daimler-Benz AG, BMW, Audi, Novartis, General Nice, BP, AB Inbev, Tyco, HP, Toshiba, NEC, Wal-Mart, Danone, Fujifilm, SPX, and Microsoft.

Thirdly, a three-year follow-up survey was conducted, focusing on the security situation of Chinese overseas investment projects in developing countries in Asia, Africa and Latin America.[49] This includes Myanmar, Cambodia, Laos, Angola, Zambia, Sudan, South Africa,

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[49] Guidance on Responsible business in conflict-affected and High-Risk Areas, 2010, a joint UN Global Compact – PRI publication http://www.calpers-governance.org/docs-sof/marketinitiatives/guidance.pdf

Brazil and Columbia. In key countries such as Myanmar, three surveys were conducted in one year. Face-to-face discussions were held with stakeholders affected by Chinese overseas investment projects – especially with the local citizens. In the process, the author came to develop a strong understanding of the environmental and social impacts of Chinese overseas investments as well as the potential conflicts and risks.

Also, preliminary assessments have been made of internal compliance mechanism in 69 of the Chinese enterprises listed in the 2011 Fortune 500. The assessment was based on information acquired through field surveys, corporate annual reports, sustainable development reports, corporate social responsibility reports, official websites and press conferences. The assessment covers three areas: establishment of internal compliance control mechanism, implementing the internal mechanism, and assessment and supervision of the mechanism.

Based on the comparison and analysis mentioned above, the author contends that from the conflict management aspect, the Chinese companies studied hold misconceptions and misunderstandings of macro-level strategic management frameworks and micro-level management tools. By using international experiences as a reference, and focusing on the prominent problems of Chinese enterprises, in the following two chapters the author provides references and guidance for Chinese enterprises in conflict management and investment security utilizing macro-level strategic management framework and micro-level management tools. This chapter focuses on elements of the macro-level framework.

3.1. Government Relations

Government relations refer to interactions between the company and government officials and agencies and organizations in the host country. These interactions include the granting of licenses, tax incentives, the use of public services and legitimate lobbying activities to gain favorable terms for business operations, etc.

Chinese overseas investment is largely focused in explorative industries such as energy and mineral exploitation. In host countries, these industries are strategic and investment requires close ties with government. In conflict-affected areas, government relations may be complicated by the absence of a legitimate or popular government. Dealing with such governments can involve certain risks. In high conflict-affected countries, human rights abuses and political corruption are common. Human rights violations by the government may expose a company to accusations of complicity in these abuses if it enjoys a close relationship with the government. Further, the perception that a company may somehow benefit from abuses may make it a focus of local disruption and international attention, jeopardizing its operation and reputation. Companies may also expose themselves to reputational risks if they engage in corrupt practices in their relations with government officials. Severely conflict-affected countries often lack the ability to manage capital flows, giving rise to a huge amount of corruption taking place between the private sector and public authorities. The means of corruption include offering and accepting bribes, kickbacks, blackmail, demanding protection fees, fraud, money laundering and embezzlement of public funds. When such corruption becomes organized and widespread within the government, there is an increased risk of public dissatisfaction, which may lead to conflict.

To address potential problems when interacting with governments, transparency is the key for Chinese enterprises to reduce the risk of being accused of bribery and corruption. Disclosure of information is a core element of transparency. The Guidelines for Multinational Enterprises issued by OECD regards information disclosure as a fundamental principle. The Dodd-Frank Wall Street Reform and Consumer Protection Act issued by the U.S. Security and Exchange Commission (SEC) requires some enterprises to disclose information of all business activities in resource exploitation and purchasing. In China, the State-Owned Assets Supervision and Administration Commission (SASAC) has issued 27 decrees, 12 of which concern the disclosure of information. Information disclosure has become a major responsibility for Chinese SOEs. However, compared with the latest international regulations and the active response of multi-national enterprises, Chinese enterprises are rather weak when it comes to information disclosure, and the continuity and the integrity of information releases are far from ideal. For example, in some cases of resettlement in overseas projects, some Chinese enterprises have negotiated and paid compensation to the central and local governments of the host country according to their agreement. However, because of the corruption of the local government and the withholding of information regarding compensation, local residents do not receive the compensation in full, and often blame the Chinese enterprises. Transparency can show the value that enterprises have created in the host country and help the public to know more about the enterprises. Although a company's ability to share information is often restricted by legal and commercial considerations, it should make best efforts to improve the transparency of relations with the host government within the permitted range of law and business, and be frank and honest in response to inquiries raised by other stakeholders.

Research Case Since 1979 the president of Angola has been directly controlling loans from the Chinese government through the National Reconstruction Office, which is run by his close allies. The system has been accused of lacking transparency. Some people in Angola have requested China to disclose the loan information but these requests were turned down. Since they are not powerful enough to oppose the government, they have turned to confront Chinese enterprises. Chinese enterprises did not do enough to communicate with the public and to disclose information, reducing public knowledge about Chinese charitable contributions given along with investments.

Meanwhile, some Chinese companies have taken advantage of the lack of transparency. Hong Kong-China International Fund Corporation (CIF) was able to contact local government officials by claiming to be a company owned by the Chinese government. CIF won projects through bribing the government, and selling contracts to Chinese subcontractors, earning huge profits. It increased costs for subcontractors and made the Chinese government a scapegoat. The scandal broke out when CIF failed to provide sufficient funds for a project worth tens of billions of US dollars. A large number of Chinese companies and tens of thousands of Chinese workers were subsequently trapped in Angola. Though Chinese Ministry of Foreign Affairs stated that CIF had no relationship with the Chinese government, the damage to China's reputation had been done. Shrouded under suspicion, such misrepresentation has affected the diplomatic relationship between China and Angola, not to mention tarnishing China's international image a trustworthy investor.

CDA Guidance Case At a mining exploration site in West Africa, the exploration team needed to acquire land for a helicopter pad in order to facilitate aerial surveying of the area. The team approached a local community chief to discuss their intention. They negotiated directly with him and agreed to pay the community a monthly fee for renting the land during the surveying period. The team hired two men from the community as security guards. The chief then held a community meeting to announce the decision. The team felt the negotiation had gone smoothly and felt they would be providing funds towards the construction of a community center. However, the chief's brother, who did not attend the community meeting, complained to the police that activities were taking place on community land without the permission of the community.

Knowing that the local government operated according to chiefdoms, the exploration team had assumed that the chief represented the interests and perspectives of the entire community. Once they asked a range of community members about how decisions are made and communicated within the community, they realized that that the chief might not represent the community. Moreover, they were not sure if the chief was telling the truth to the community about the agreement with the company. The team realized that a better option would be to conduct negotiations with the chief in public meetings to ensure that no one in the community would oppose the decision on the basis of feeling left out. Open and public discussions would give little reason for community members to obstruct current or future exploration activities.

Interactions between foreign enterprises and local governments concerning conflict-related issues may be considered unwelcome interventions in internal affairs. However, this does not mean that enterprises should not act. Silence toward governments' wrongdoing may be seen as indifference and could arouse anger from parties involved in the conflict. The risk will ultimately fall on enterprises, and in some cases, enterprises may become the scapegoat for host government officials' misconduct.

Enterprises should share their concerns with the government. For example, an enterprise can publicly discuss and privately consult with the government to illustrate that peace and stability are the common interests of both the government and the enterprise. When an incident takes place, the enterprise should clearly express their worries and dissatisfactions to government officials. The enterprise can also help the government with social problems, such as providing training to local residents on livelihood and unemployment reduction. Enterprises can participate in forums held by multiple stakeholders to promote increased consensus between different parties on the issue of peace. Enterprises can join international initiatives to make clear its positions, such as joining the CEO Water Mandate or the Extractive Industries Transparency Initiative. Joining such initiatives can also provide a platform for interaction with the government on issues of transparency and social responsibility.

Projects that create large revenues may create tensions between local governments, or between local governments and national governments. Even social investment projects, which are implemented in good faith, may also be accused of weakening the service role of the government. Enterprises need to investigate and analyze local investment risks by collecting information not only from the local government, but also from local NGOs, communities and even parties that oppose the government. If decisions are based only on information from the government, enterprises may become trapped in local political conflicts. However, Chinese companies are usually only used to dealing directly with governments. Generally, they do not know how to approach and communicate with NGOs actors.

Research Case The suspension of construction of Myanmar's Myitsone Dam, also known as "Overseas Three Gorges Dam," provides a number of profound lessons. The Myitsone Dam project was proposed and launched with tremendous support from the Burmese government. However, following the elections, the new civilian government stopped the Myitsone Dam project, which was worth $3.6 billion USD, and caused significant loss to the Chinese enterprise involved.

There were opportunities for engaging the government during various points of the project cycle, both from a pro-active and reactive stance. Based on analysis of the situation in economic, ethical and legal terms, a number of engagement opportunities existed. However, the enterprise responsible for the project failed to grasp the changes in local situations. They did not explore opportunities to build constructive interaction with the government or take the necessary measures to deal with conflicts, including educating themselves about ethnic issues, democracy issues, livelihood issues, environmental evaluation criteria and cultural protection issues.

UNGC Guidance Case The following is an example of a successful case. A community meeting in Southern Africa was bombed amid tensions over a company's resettlement program. The company, which had major operations in the area, was then faced with a problem: how should we react to this bombing? The company rejected silence or withdrawal from the area. Instead, it embraced a three-fold strategy. Firstly, it wrote a letter of protest to the government, in which it issued a public statement condemning the incident and calling for a public inquiry. Secondly, the enterprise reiterated its willingness to provide training on resettlement issues to the local authorities in order to mitigate the tension. Thirdly, the enterprise initiated and co-hosted a multi-stakeholder forum, discussing the most effective means of creating the right business climate for investment and how to reduce investors' concern of being accused as complicit in human rights abuses. This led to the establishment of a Global Compact Local Network. It was also a positive advertisement for the enterprise to clarify any misunderstandings.

UNGC Guidance Case A company with oil and gas interests in the Middle East was aware of the risk that government relations may bring before it went into negotiation with a regional government. Before signing the agreement, the company undertook due diligence and extensive stakeholder engagement, both locally and internationally. It aimed to evaluate the exact nature of the risks posed by and to the project as well as identifying strategies to minimize those risks. The first strategy the company employed was to demand the redrawing of the boundaries for one of the projects to lie solely within the area under the recognized control of the regional authority. Secondly, the company negotiated an option for itself to leave the project after a set period, which allowed the regional and central government time to resolve outstanding legal and political issues associated with the creation of production-sharing agreements. Thirdly, the company publicized payments made to the regional government to support infrastructure and capacity building projects in the region. Fourthly, the company confirmed its mutual commitment with the regional government to transparency in promoting respect for and compliance with voluntary principles and international best practices such as the Extractive Industries Transparency Initiative or the Voluntary Principles on Security and Human Rights. A creative strategy developed through extensive stakeholder consultation. Collaboration with government actors reduced risks to the company and clarified the content and structure of relations between the company and different government actors. Both the company and governments encouraged transparency and promoted human rights observance.

3.2. Community Relations and Consultation Mechanisms

Chinese state-owned enterprises often have easy access to investing in certain countries in Asia, Africa and Latin America because of China's political and diplomatic influence and the low investment thresholds in some recipient countries. The relationship with governments and business partners is given much more attention by Chinese enterprises than the relationship with communities or CSOs/NGOs. This results in a gap, where communities and local CSOs, feel their concerns are often not considered. In conflict-affected countries, the government cannot control everything. Once political turbulence arises, especially if forces opposed to the government rise, Chinese enterprises face adjustments and some investment might not be recoverable. Chinese enterprises usually do not realize the problem promptly or deal with early disputes in a constructive and effective fashion. This results in mounting discontent among affected people and increasing tension between Chinese enterprises and local communities. In order to control and mitigate such risks, China needs a more balanced investment model with closer links to the communities. Such a model, emphasizing local communities' welfare and quality of life, can help to develop a more positive public opinion of Chinese investments.

CSOs/NGOs have become a major force in addressing environmental and social impacts of investment. Many of these organizations have strong social influence and credibility and have close relationships with the press, local communities and international organizations. As a result, the enterprises that invest and do business in these countries are often faced with pressure and criticism from NGOs in the areas of labor, environment and human rights. For example, the international organization Bank Track tracks the operations of private banks and their effects on society and the environment. Bank Watch monitors public funds in central and eastern Europe. Therefore, transnational enterprises are very concerned about consultation with NGOs and understand the need for local support in conflict risk management.

Chinese enterprises should realize that the trust and respect of society is as valuable as the tangible assets. The enterprises should attach great importance to relationships with communities. Communities should be considered as partners rather than a risk factor. Transparency can also be improved by working closely with local communities. To strengthen relationships with communities, a strategic community consultation strategy needs to be established to show that the enterprise is approachable and responsible. This consultation strategy should include regular engagement on a range of forums, as well as training and preparation of certain staff to be qualified for this work. Staff assigned to such roles need to have necessary clearances and authority to engage local stakeholders. In community consultation, enterprises should show that they respect the interests of all parties. It is especially important when there is tension among different local interest groups. Enterprises can also show their concerns about social welfare, and this can contribute to building and improving the company image.

The interests of different stakeholders should be analyzed in order to develop different consultation strategies appropriate to different groups. It is important to involve stakeholders from varied backgrounds in order to hear more perspectives. This will aid the enterprise's understanding of the local situation. If stakeholder consultations only involve a small group of people, this may cause the public to believe that they need to compete for the chance to communicate with the enterprise, which may give rise to a conflict. Although it is more complicated to work together with people who hold different opinions, it is often beneficial to communicate directly and to resolve major disagreements. Some organizations may oppose an investment project, but regardless of whether or not cooperation can finally be achieved, the enterprise should not avoid communication with such groups. The enterprise may gain inspiration from listening to these opinions, and it may help them to understand the reasons why their enterprise is receiving criticism or opposition. Often some groups will oppose a project because they are suspicious of its legitimacy, but sometimes opposition is due to a misunderstanding of the enterprise and how it is run. Under these circumstances, it can be very useful for the enterprise to emphasize its support for sustainable development during communication.

Consultation mechanisms can involve various methods, such as issuing corporate social responsibility reports, organizing meetings with communities, and establishing complaint channels. Enterprises can also communicate their vision, corporate governance structures, and social investments, especially relocation and compensation plans, through private channels including the local chamber of commerce, media, and CSOs. Through such communication, the benefits of the investment can more effectively reach local communities and China can avoid taking blame for the corruption of local authorities. The forms of consultation should be as varied as possible, such as informal events or festivals, official meetings, or informal conversations. When building community participation, processes can be informal. But a respectful attitude is necessary to avoid rigidity. Daily living, dining, shopping can all be different channels to observe, understand and communicate. It is very important to establish friendly relations with local community members.

Community consultation is an open, transparent, and continuous "consultative" process, rather than a "negotiating" process. In a context of violence and low trust, tension may exist between different groups or within groups. An early, continuous, and appropriate consultation can create a more stable environment in which risks can be identified and dealt with. In the initial stage of investment and business, enterprises should actively consult with communities by providing information of exploration projects and establishing mutual trust. Lack of interaction with local communities, or communication that comes only after contracts are already signed, can make people think that they are not being fully consulted about the problems that affect their daily lives. As a result, tensions between an enterprise and the community may escalate, and may even lead to the suspension of business operations.

Effective consultation needs sincere attitudes. Some Chinese enterprises see communications with communities as a way to advertise, but this self-centered communication style does not help enterprises to learn new information, and may even be met with more suspicion. In addition, when enterprises talk only about the benefits they may offer to communities, this may generate unrealistically high expectations within communities, which can lead to profound disappointment and resentment when the expectations are not realized. Every word and action in communications with the community can reflect whether or not the enterprise has a sincere attitude and fully respects communities' opinions. This can determine the success of the consultations. For instance, when an enterprise enters the local community for the first time, it should make self-introductions and present letters of introduction containing basic information. It should explicitly tell community members the purpose of the visit and actively provide information regarding the structure, target groups, objective and time of consultations. The questions raised by consultation participants should be answered frankly. As for complaints, enterprises should apologize and provide explanations in order to gain understanding and support. For issues that cannot be resolved in the short-term, the enterprise can promise to make their best efforts to resolve these issues, and realize these promises with follow-up actions. A risk may arise when companies make promises to communities but don't deliver. Communities need to be aware of anticipated negative impacts and to have realistic expectations from the beginning. For issues that can be resolved with relative ease, the enterprise should document the concern and remedy the problems as soon as possible.

Consultation with local community leaders is an efficient way to learn about the needs of the community. In the areas surrounding the project, there are always some influential organizations or individuals, including international or local NGOs, media, religious leaders, and scholars. They do not only represent the opinions of the local residents but also serve as a platform to influence other important stakeholders. In some rural communities, local landowners may refuse to make contact with enterprises before the enterprises approach the community leader and show the leader their credentials. Local NGOs and community leaders often have in-depth knowledge about community problems, and enterprises can utilize this knowledge if they actively express sincere willingness to promote the development of the community. However, in conflict-affected areas, leaders may have problems of legitimacy. The enterprise should learn to identify the legitimate representatives of the community and to assess whether the leaders have wide support from the people they claim to represent. When an enterprise first approaches the community, they should have some knowledge about the leadership in the area. Cooperating with them in conflict management can bring about a win-win situation. The identification and selection of potential partners is very important.

The CDA guide provides the following points that should be considered when identifying potential partners:

- *Vision and mission of the organization* – What it is about and why it operates in certain communities.
- *Who the organization represents, and who it does not* – Some organizations are designed to represent key decision-making stakeholders, whereas others have a broader reach and represent a wide segment of the population.
- *Who the organization speaks to* – A local office of an international NGO may share information and concerns with its global headquarters and, through advocacy activities, a broad global public. A local youth group, on the other hand, may be relatively unknown and have little influence outside of the local community.
- *Which group of the community accepts the organization* – It is important to ascertain whether those who the organization claims to represent really support the organization.
- *What the organization wants* – Organizations have widely varying interests, purposes, and activities. All of these will depend upon their relationships with the exploration project.
- What the organization is capable of doing – Organizational capacities and resources range widely. An organization's capacities play a large part in determining what role it can play in, and in relation to, collaborating with the exploration project.

Meanwhile, the enterprise should also pay equal attention to local residents. When providing different opportunities for the community, such as employment, the enterprise should adopt an inclusive approach and stay sensitive to possible conflicts at the same time. For instance, when employing people who previously participated in armed conflicts, enterprises need to make sure that they will not have armed conflicts with others again. Local employees can also be important assets. They can provide information about the community and can tell family, neighbors and others about their own experiences with the enterprise.

Dispute resolution mechanisms should be established in accordance with the standards adopted by international organizations such as the United Nations. Stakeholders should also be informed of the enterprise's policies and dispute resolution procedures so that the community can be more involved and able to utilize these mechanisms. If the enterprise can guarantee that these complaints will be dealt with promptly, the enterprise can improve the chances that it will be regarded as a member of the community rather than an outsider. On the other hand, without dispute resolution channels, communities may resort to other options, including even violence, which may eventually cost the enterprise greater expense.

CDA Guidance Case At an exploration site in South America, the community relation's team developed a strategy of applying for permits to do exploration activities on a short-term basis. Instead of asking for a community "license to explore" for three years, they asked the community for permits of one-to-three months during early stages of the project. They found this to be one of the best strategies in building trust within the community. It has allowed them to more closely manage their relationship, provide regular and on-going communication, and more easily deliver on the promises made on exploration activities. Once the community's confidence in the company's ability to deliver on its commitments was built, the team expects to spend less time and resources to negotiate longer permits in the future.

UNGC Guidance Case Conflicts over the impacts of its operations arose between local communities and an oil company in Asia. The conflicts threatened delays and financial losses for the company. The oil company responded with four main strategies to engage communities more effectively: 1) community outreach and interviews with key opinion leaders and decision makers; 2) information dissemination, education, and communication activities for the whole community; 3) perception surveys and participatory workshops to introduce the project and validate initial survey results, and 4) participatory involvement in the formulation of environmental management plans. The cost of this engagement was estimated at approximately $6 million USD on a total project cost of $4.5 billion USD (0.13% of total costs). Based on the calculations of the company, by engaging with local communities, it managed to avoid project delays of approximately 10-15 days, equivalent to an estimated savings of $50-72 million USD.

The consultation mechanism should include a formalized, yet adaptable, procedure to consult with local people. The procedure should be transparent and include publication of meeting minutes and records of the commitments made by the company. But a one-size-fits-all procedure or standard cannot be applied in every community. Rather, companies need to develop and adapt approaches to engagement that are context-specific, based, in part, on what communities say about how they want to be consulted by the company. This procedure needs to be revised as the needs and interests of local communities change. A formalized procedure not only helps circumvent the adverse effects that may arise from poor communication, but can also show respect to the local community by presenting an attentive attitude and actively listening to the local residents. It can also help build a "stable and responsible partner" image in the community.

Companies can organize discussion about risks and opportunities and ask project managers, experts and security staff to participate. Employees are required to submit reports so targeted guidance can be carried out accordingly. For example, local employees can be required to submit a field work report every week and the report should contain certain contents: *Who did I talk to during this time? What was the conversation about? What is the atmosphere among community members?*

The related standards can refer to the current international practices and standards in Chapter 2. Complying with these standards requires community participation at many stages of business operations, for example, in conducting impact analysis, hiring local employees and in designing and implementing community projects. Interdisciplinary coordination and accountability mechanisms should be established to make sure that the enterprise departments which have contacts with the local community can promote constructive community participation.

Enterprises should fulfill their commitments and inform the community if it cannot fulfill them in time. An index should be established to measure the qualitative and quantitative changes in bilateral relations, tracking the changes of community opinions and views, and obtaining timely feedback on the enterprise's performance from the community.

A participatory attitude should be adopted when tracking and monitoring the relationship changes. This enhances trust and ensures the enterprise completely understands the opinions and views of local people. The normative requirements are embodied in many details. Notes or instruction manuals should be made for community participation and access to the community. Special guidance and training should be provided for the employees that are going into the community. Training can include how to prepare business cards, how to respond to different questions, how to introduce the enterprise's objectives, local employment prospects, local purchases and the payment of land use fees.

Adopting these standards also requires skillful questioning and listening capacity. How the questions are asked is equally important as the answers to those questions. Some simple questions can be asked first to show curiosity and interest in this community, and then the topics can be extended to the background and operation of the community. As for some sensitive problems, the enterprises do not need to ask the community members directly. Instead they can obtain the information through indirect questions.

At a minimum, the following information should be collected.

Community Background:

- How is the local community organized?
- How does the community make decisions?
- Is anyone excluded from the process of decision-making in the community?
- How do local residents express their opinions?
- What is the decision-making process for important issues?
- What are the sources of income of the local community?
- How does the local community acquire news and information?
- How does the public value the political rights, religious and culture rights, labor rights and the rights of ethnic groups?
- How is conflict addressed in the community, and/or what are the local arbitration processes? Or problem-solving processes?

Community Opinion about Enterprises and Projects:

- What is the attitude of the local government towards the industry the enterprise operates?
- How does the community respond when a company applies for an exploration permit?
- Has the community ever dealt with similar enterprises in the same industry before?
- What was the situation like then?
- What is the attitude of the local community towards this industry?
- Has there been any protest against the industry?
- Who led the protest?

Potential risks:

- Is it necessary to pay special attention to the risks regarding personnel safety and security?
- Are there any major local, social or political problems that need extra attention?
- What are the local conflicts? What are the history and characteristics of these conflicts?
- Has there ever been a major conflict in the area?
- What were the reasons and the context of the incident?
- Is there continuous and open violence in the locality?
- To what extent and how are human rights protected?
- Are there any unresolved historical problems?
- Are there any unresolved problems regarding issues such as land use rights, terms of the use, compensation fees and boundaries?

In addition to questioning skills, employees should also receive listening skills training. In the community information gathering process, a large amount of information can be gathered. With the help of this valuable information, enterprises can gain a better understanding of the local background and can actively promote its relationship with the local community.

According to the CDA guide, the following principles should be followed in order to improve questioning and listening skills:

1. *Test the assumptions*. If someone has been in the community for any period of time, he or she would likely form his or her own opinions and assumptions about the local context. These assumptions can be tested with questions to other staff and, especially, local stakeholders.
2. *Look for blind spots*. Ask people about the things no one has talked about before.
3. Incorporate questions into regular work activities. Use questions as a guide but allow the conversation to flow naturally.
4. *Use open-ended questions*. That is, questions that do not invite a "yes" or "no" answer but rather encourage people to speak their minds and elaborate.
5. *Ask different questions around the same subject*. This creates a way to press for more information and further analysis of potential conflicts.
6. *Listen carefully.* Listen to how people speak and the words they use to describe the situation and also be aware about what people are not talking about.
7. *When speaking to local communities, be careful not to bring up words, like "conflict" or "human rights abuses."* These words may have potential negative connotations or insinuate negative situations.
8. *Try to build off of the words and phrases that the local people use*. Consider both official and unofficial perspectives and formal and informal relationships.
9. *As people are following certain steps to analyze, they will find that questions are interrelated.* For example, if the answer to question A contradicts that of question B, revisiting previous discussions will be necessary.
10. *Demonstrate you are listening by summarizing the points*.

3.3 Corporate Social Responsibility and Social Investment

The CSR movement has now become a global movement and has attracted considerable attention from governments and the public. CSR has been viewed as a significant basis and effective channel for sustainable development and has become popular around the globe and the process of standardization is accelerating. In 2010, the International Organization for Standardization (ISO) released ISO26000, which defines CSR and makes it a standard part of business responsibilities. Some 35 countries transformed ISO26000 into their national standards in 2011.[50]

[50] Nanfang Daily, 2013-04-12, http://epaper.nfdaily.cn/html/2013-04/12/content_7181301.htm

Two reports released by two separate Chinese commissions show that China is managing foreign investors' behaviors and protecting Chinese corporations' international credit and reputation by making policies and guidelines so as to encourage them to fulfill their social responsibilities.[51]

However, most Chinese corporations have not yet fully understood the concept of CSR and have not prepared for its implementation. Some Chinese companies focus on maximizing short-term profits, and in the process they ignore their social responsibility to the local people. The lack of enthusiasm for charity is an obvious example. When there is a charity event, the sponsors listed are frequently western companies.[52] Some big mining companies do not provide enough financial support to local communities and do not properly communicate with the public, and in some cases this has resulted in protests. Some protests even get the support of the local authorities. Some companies have realized the importance of CSR and increased their social investments, however, they have not designed specific strategies and/or have not implemented CSR activities in an effective way.

"Social investment refers to voluntary, and sometimes legally-mandated, financial contributions by companies in support of local community development. Companies, no matter their size, may have the opportunity to deliver long-lasting programs that benefit local and regional communities when social investment is strategically aligned with core business activities. Social investment projects that are not aligned with core business strategy and competencies may cause the company to undertake activities in which it has limited expertise and knowledge. This can reduce the likelihood of success. Companies can employ the same standards in developing social investment strategies as in other aspects of business operations. Strategic social investment being aligned with the business case also means that the scope of development programs agreed upon up front in the contractual agreement should also be looked at more strategically. Companies can design all social investments with a clear schedule, exit strategy, project transfer plan to local communities, provisions of services that need to be paid for and a blueprint for continued activity without financial input from the company."[53]

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51 The two reports cited are "Guidelines for State Owned Enterprises to Fulfill Social Responsibilities" released by the State-Owned Assets Supervision and Administration Commission of the State Council in December 2007 and "Green Credit Guidelines" released by China Banking Regulatory Commission (CBRC) in February 2012.

52 International Business News, 2011-03-21, http://www.ccpit.org/Contents/Channel_1087/2007/0201/25459/content_25459.htm

53 Guidance on Responsible business in conflict-affected and High-Risk Areas, 2010, a joint UN Global Compact – PRI publication http://www.calpers-governance.org/docs-sof/marketinitiatives/guidance.pdf

Companies can create specific environmental and social responsibility management departments by hiring professionals and consultant experts and cooperating with NGOs. Based on the evaluation of the corporate social responsibility environment and situation, the departments shall define the main elements of their social investment, develop a clear social investment vision, establish a social investment strategy plan and publish corporate social responsibility reports. When establishing corporate social investment strategy plans, companies can analyze their impacts on the local environment and society and attempt to develop the most appropriate plan to reduce negative impacts. Companies can employ existing standards and guidance on social investment, such as the Principles for Social Investment (PSI) .[54]

Social investment is not simply a financial issue, but also about communication and community development. It has to be based on professional communication, public participation and community conflict management. If communities are not involved in the identification and development of social projects, or if they feel no ownership, social investment efforts may lack long-term impacts, or yield minimal goodwill between the company and communities. In a conflict-affected or high-risk area, this may increase the perception that the company does not care about the community and could make it a target for hostile action. Companies should establish strategic social investment programs as a component of local stakeholder engagement and consultation. Engaging the community in social investment may serve as a means to bring conflicting groups together rather than exacerbate existing tensions and divisions. It can also help companies to gain political support among local communities for business activities. Companies should develop an exit strategy in conjunction with local communities, local civil society and local and national government, to ensure that social investment projects can be successfully handed off and taken over by other parties including local and national governments.

Failing to implement a strategic social investment plan may cause a waste of company resources. Companies should ensure that their social investment strategy is designed specifically for the local context, taking into account risks in the conflict-affected area. Companies should develop risk mitigation strategies and policies that specifically address impacts of social investment and should demonstrate transparency, equity and

[54] Principles for Social Investment (PSI), UN Global Compact, http://www.unglobalcompact.org/docs/issues_doc/development/PSI.pdf

fairness in decision-making processes so as to reduce public suspicions of corruption and favoritism. Social investment cannot be used to replace the company's obligations to mitigate or compensate for its operations' impacts or other business activities such as local hiring, contracting, waste management, or resettlement compensation. Core business activities, however, can be conducted in a socially beneficial way to complement social investment.

Companies should also pay attention to sustainability, evaluate how social investment projects will contribute to the company's strategy of managing its impacts on communities. Companies shall utilize ongoing stakeholder engagement as a method to inform, design and develop social investment projects. Companies can clearly define objectives that are linked to business operations. They can help local communities achieve their development priorities and create sustainable, social and economic development. For example, alternative livelihood training for relocated residents may mitigate negative impacts associated with relocation and enhance a compensation package.

Companies should take into consideration the long-term impacts of a social investment strategy when evaluating the sustainability of projects. Unsustainable social investments, especially the provision of free services in conflict-affected or high-risk areas, can over time, be taken for granted by local stakeholders, creating recurrent expenditures for the company. Companies should avoid providing free social services, thus ensuring that social investment is strengthening local capacity rather than substituting government services. Yet, companies can work directly with the central and local government to ensure that social investment strategies are in line with regional and local community development plans.

3.4. Due Diligence of Business Partners

After the economic crisis, many anti-corruption laws and regulations such as America's *Foreign Corrupt Practices Act* (FCPA) have been strengthened through increased enforcement. The U.S. Department of Justice sentenced 35 foreign corrupt cases across the globe in 2010, five of which involved Chinese companies (14% of the total). In 2009, the figure was 10 out of 44, which made up 23 percent. Since 2010, the U.S. Security and Exchange Commission (SEC) started a wide-ranging investigation into Chinese corporations and brokers. Since April 2011, more than 130 Chinese companies have been listed in the American securities traders' blacklist. Many Chinese companies' stock prices fell below their initial offering prices due to this blacklisting. Since 2008, the World Bank has released a list of Chinese companies, banned from working on projects funded by the World Bank for a certain period of time due to their suspicion of being involved in fraud and bribery.

On July 21st, 2010, the United States released the *Dodd-Frank Wall Street Reform and Consumer Protection Laws*, regulating that once reported bribery was proven, the informer would get 10% to 30% of the fine as a reward. This new informant reward provision soon brought more litigation to the SEC. In July 2011, the United Kingdom started to pay increased attention and released the most severe law in its history, the *Bribery Act*. According to this Act, if a company does not establish appropriate regulatory controls for anti-corruption, it is responsible not only for its own violations, but also takes strict joint responsibility of its business partners' violations.

A company's business partner could become a compliance risk for the company. In May 2011, the United Nations Global Compact held its 8th Advisory Committee in Denmark. One of its main issues was the due diligence investigation of global supply chain compliance and anti-corruption management. Before building a business relationship, many transnational companies have taken appropriate measures to conduct compliance audits, manage, communicate, train and guide their brokers, consultants, contractors, and other business partners based on their strategy of sustainable development.

Currently, many large transnational companies' commercial conduct guidelines clearly forbid actions that influence an official act or obtain improper benefit in commercial relations by providing money or other valuable things to government officials or private businessmen through business partners. They even do not allow any intentions to impose any improper influence. Many companies have developed due diligence investigation tools to evaluate all potential business partners' integrity based on various risk factors. First, they place expected business partnership into a certain risk category. Then, they conduct a focused investigation, deciding on whether to establish a partnership, and if so, what kinds of partnership according to the investigations results. Any business partners' commercial, financial, or ethical violation can be listed as a "risk sign." A risk sign does not mean the end of a partnership, but means that an investigation into the partner's integrity is required, including a due diligence investigation.

Research Case Siemens AG went through the most severe punishment in the history of the FCPA, because it became involved in a serious bribery scandal, which affected its operations all around the world, especially in a number of developing countries. Since then, the company has devoted serious efforts to improving its compliance and anti-corruption mechanism. According to its newest regulations, an effective and approved due diligence investigation is a precondition for cooperation with its business partners. Its business relations are divided into three risk levels, including "low risk," "medium risk," and "high risk." The results of an approved due diligence investigation are valid for three years and must be updated after expiration. "Risk signs" include:

- Information that the business partner has been involved in bribery (for example, if websites or credible media sources raise doubts about its honesty);
- A business partner insisting on anonymity;
- Business partners lack technical ability, resources or experience to be able to provide services;
- Unusual payment methods (for example, payment to a third country);
- Inconsistency or lack of details in invoices issued by the business partner;
- Business partner is able to influence governments' decisions;
- Just prior to contract being signed, the contracting party suddenly puts forward the need for business partners;
- The business partner is from a country with a low TI/CPI figure. (This does not necessarily become a "risk sign," but needs to be considered together with the entire context of the partnership.)

Business partners have the obligation to choose appropriate sub-contractors, with each new sub approved by Siemens. Due diligence investigations have to cover sub-contractors as well. Only when the sub-contractor accepts to be bound by the equal compliance terms between Siemens and its business partners will Siemens approve the sub-contractor.

For Chinese companies, the compliance issue of third parties in the supply chain is a significant conflict risk. For example, the author's research found that third party corruption was a big issue in the case of the China-Myanmar oil and gas pipeline project. Besides the compliance of the company itself, companies must do due diligence to investigate, guide and supervise their partners based on international standards. This is the latest requirement of recent transnational anti-corruption statutes such as the *Bribery Act* of the United Kingdom.

United Nations Global Compact: Guidance on Responsible Business in Conflict-Affected and High-Risk Areas: A Resource for Companies and Investors suggests that companies:

- Conduct an extensive mapping exercise and focus due diligence on their suppliers to verify the origin of products they purchase, as well as understand the set of risks involved at different levels of the supply chain.
- Expand their supply chain due diligence process to sub-tier suppliers, which are responsible for providing goods and services to companies' strategic suppliers. In conflict-affected and high-risk areas, these sub-tier suppliers often provide raw materials and thus pose the most significant challenge to companies in implementing responsible business practices.
- Carefully monitor their business relations, transactions as well as flows of funds and resources and develop a rigorous supply chain management system to assess and monitor if and how their suppliers obtain resources and raw materials in conflict-affected and high-risk areas.
- Set up procedures for supply chain engagement and regularly communicate with suppliers about the company's expectations and standards. It is important that companies encourage their suppliers and sub-tier suppliers to develop the capacity to implement responsible business practices.
- Carefully examine and monitor existing and newly established business relations and transactions to verify that they do not supply funding or other resources to armed groups. This is to ensure that they and their suppliers are not providing funding or support to armed actors who may benefit from revenues generated by the sale of such goods and resources. The risk of reputational loss from being involved in a conflict is difficult to recover from.

UNGC Guidance Case A large North American company produces computers and related hardware products. While their direct suppliers do not necessarily operate in conflict-affected and high-risk areas, they have learned that critical raw materials used in their products may have come from areas controlled by armed actors. The company joined forces with other industry peers to create a certification mechanism on certain minerals such as tin, coltan and cassiterite coming from conflict-affected and high-risk countries. It also asked some of its suppliers – those deemed “high risk”– to complete a self-assessment questionnaire to identify potential social and environmental responsibility performance risks. Their self-assessment began with an important psychological effect. They helped its suppliers become more familiar with the company’s expectations of what it means to conform to the supply chain code of conduct. The company then reviewed the results of the self-assessment and asked some of them to implement an improvement plan. The company has engaged more than 600 suppliers in this process and conducted over 500 supplier site-audits in the last ten years. The company has made available as much information on those audits as possible. It has listed the majority of its suppliers in an effort to be more transparent.

3.5. Compliance Information

Disclosure of compliance information is also essential to transparency. In recent years, more international regulations have been issued to require enterprises involved in oil, natural gas and mining industries to disclose their payment to governments. For example, in 2010, the Hong Kong Exchange and Clearing Limited made new regulations regarding compliance information disclosure when mining enterprises are listed. It requires that enterprises provide information of the tax payments made to host country governments, as well as royalties and other payments. Section 1504 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* requires American-listed companies to disclose their payments to governments for oil, natural gas and mineral resources. In October 2011, the European Council presented proposals for similar legal standards, requiring large oil, natural gas, mineral and timber companies, no matter whether listed in the European Union or not, to disclose similar information.

According to the relative experience of transnational enterprises, compliance reports usually involve three major elements of compliance management: 1) establishment of the compliance mechanism; 2) implementation of the mechanism; and 3) supervision and improvement of the mechanism. The report of establishment should include at least fundamental principles on compliance and specific policies on compliance. The report of implementation should include personnel management, financial audit and supply chain management. The report of supervision and improvement should include monitoring and assessment of compliance risk, investigation and management of non-compliance, and the disclosure of compliance information.

The corporate compliance reports can be flexible according to the special features of different businesses, business locations and corporation size. However, reports must abide by international and national compliance regulations. The report can be published as a single report, or a part of the corporate annual report, corporate sustainable development report or the corporate social responsibility report. Below is an anti-corruption compliance report framework for reference. This framework is based on the related international guidelines and the experience of transnational enterprises.

Internal Compliance Report Framework for Chinese Enterprises

Element	Classifications of indexes	Elements of the indexes	Points
Establishment of the mechanism	Establishment of fundamental principles on compliance	Stress the importance of compliance including anti-corruption in various formats.	1
		Publicly declare zero tolerance for corruption.	2
		Establish special organization for compliance and anti-corruption.	2
	Establishment of specific policies on compliance	Make rules directed at important departments of compliance and anti-corruption, important places and important businesses.	1
		Incorporate important regulations regarding compliance and anti-corruption into the employee code of conduct. For example, the regulations of favor fees, facilitating payments, gifts, entertainment expenses, promotion fees and charity donations.	2
		Set up the mechanism for avoiding conflicts of interests in the decision-making procedure.	2

Implementation of the compliance mechanism	Compliance personnel management	Communication and training on the policy and procedure of corporate compliance and anti-corruption are provided to employees.	1
		Implement compliance and anti-corruption management responsibility and accountability system.	2
	Compliance financial audit management	Internal compliance and anti-corruption audit procedure is available.	1
		Internal compliance and anti-corruption accounting procedure is available.	2
	Compliance supply chain management	Examine the suppliers, clients, investment partners and other partners.	1
		Support and encourage business partners to oppose corruption.	2
Supervision and improvement	The compliance risk assessment monitoring	Provide communication and report channels for compliance and anti-corruption.	1
		Conduct risk assessment of the areas where corruption might occur.	2
		Employ independent third-party to monitor the anti-corruption system.	2
	Investigation of illegal incidents	Provide follow-up and investigation mechanism for charges and inquiries.	1
		The management will conduct inspection of the results of supervision and improvement.	2
	The disclosure of compliance information	Disclose the executive conditions of compliance and anti-corruption systems regularly or occasionally in various forms.	1
		Disclose corruption cases.	2

3.6. Sustainable Development

Issues such as the environment, labor and human rights have been repeatedly raised in international negotiations over the past few years. From a moral perspective, the principle of sustainable development requires that investment and trade regulations consider economic activities and the environment as a whole. From a legal perspective, international regulations need to be specified in order to avoid disputes when investment and trade overlap with environmental issues. From a diplomatic perspective, China should actively deal with environmental problems as a responsible country. China can also refer to and learn from previous successful international experiences.

Environmental protection is a key part of risk management. Enterprises should abide by the laws and regulations of China and those of host countries. They should also comply with internationally recognized systems of rules regarding sustainable development in the areas of energy, mining, agriculture and finance. This includes standards such as the *Hydropower Sustainability Guidelines* and the *Hydropower Sustainability Assessment Protocol* issued by the International Hydropower Association, *Environmental, Health and Safety Guidelines for Mining* developed by International Finance Corporation, and the *Equator Principles* which set environmental and social standards for international project financing. Chinese enterprises can adopt these international standards and minimize the environmental and social impacts on host countries of investment and economic cooperation. If the host country is a developing country with less environmental standards that are less well developed than those in China, enterprises should at least abide by Chinese corporate environmental and social responsibility standards.

With the increase in social conflicts caused by environmental problems, the Chinese government has realized and acted upon the needs of overseas enterprises for environmental policies. On August 27, 2007, the State Forestry Administration along with the Ministry of Commerce issued *A Guide on Sustainable Overseas Forests Management and Utilization by Chinese Enterprises*, and aims to guide and regulate the sustainable management of overseas forest resources by Chinese enterprises, and promoted the sustainable development of forestry in host countries in order to maintain the international image of China as a responsible country. In 2004, the Export-Import Bank of China also passed its *Environmental and Social Impact Assessment of China Export and Import Bank's Loan Projects* and made revisions in September 2007.

In 2010, the Ministry of Commerce issued *Guidance on the 2010 National Outward Investment Cooperation*, which urged enterprises going out to establish win-win situations, obey laws and regulations, respect local religions and customs, actively fulfill social responsibilities, establish harmonious relationships and enhance sustainable development capabilities. China is also closely following or actively participating in a number of international "soft rule" standards relating to trade and investment, such as the *Equator Principles, Extractive*

Industries Transparency Initiative, Forest Stewardship Council and Multi-Fiber Agreement. Relevant departments have now begun research on the environmental protection policy of China's outward investment and supporting enterprises and have organized the writing of Guidelines for *Environment Protection of Chinese Enterprises Overseas Investment*. This is of great importance for maintaining the international image of China as a responsible country, and is also necessary to promote green globalization.

More efforts should be made to develop policy guidance and education on sustainable development and green transformation. Firstly, the ideas and experience of sustainable development and green transformation can be introduced through the internet, seminars and training classes, assisted by the government, industry associations, chambers of commerce and by other methods. Secondly, the idea of sustainable development and green transformation can be included in overseas investment policy, and the transformation towards this growth model should be accelerated. Thirdly, management systems should address the balance between project construction, corporate responsibility and sustainable development. The establishment of an economic compensation system for developing overseas resources can also be further studied. Fourthly, Chinese enterprises should be encouraged to abide by environmental protection systems and actively protect the environment by working with local governments and stakeholders.

Meanwhile, the capacity of enterprises, especially small enterprises, to handle environmental issues should be strengthened. Small- and medium-sized overseas enterprises often do not have adequate capacities and resources for environmental protection, and the standard and compliance of their businesses still needs improvement. Small- and medium-sized enterprises need help in technical equipment, consulting, financing, talents recruitment, management, and other key areas to build their own capacity for dealing with environmental issues. Public institutions should also be established to help provide these services for overseas investors.

Moreover, economic incentives should be given to small- and medium-sized enterprises when they fulfill their social and environmental responsibility in host countries. Those enterprises, which have actively shouldered their environmental responsibilities, should be provided with policy incentives including reduction of taxes, favorable financing and quick customs clearance. The evaluation of these enterprises should be based on shared information provided by the Ministry of Environmental Protection, Customs, State Administration for

Industry and Commerce, the relevant tax departments, China Banking Regulatory Commission, embassies and consulates and credible civil society groups in China and in host countries. For those enterprises that fail to fulfill social responsibility and damage the image of Chinese enterprises overseas, punitive measures should be adopted and documented. Meanwhile, Chinese small- and medium-sized enterprises should be encouraged to gain legal licenses in host countries and the government should examine whether such companies are competent to conduct overseas operations.

3.7. Distribution of Benefits

Investment projects can bring significant economic benefits to the local community, including job opportunities, hiring of local contractors and community projects. In addition, there are intangible benefits. However, in high conflict-affected countries, distribution of investment benefits may bring conflicts of interests. Under the diplomatic principle of non-interference with internal affairs, Chinese companies generally lack sensitivity regarding the issue of distributing benefits.

Research Case Myanmar's Myitsone Dam is within the jurisdiction of the military government, but the inundated area is within the area controlled by the Kachin Independence Organization. The military government's arbitrary distribution of the Myitsone Dam investment benefits gave rise to the perception that Chinese investment corporations were the beneficiary of a conspiracy and unjust conduct, and therefore they became the focus of tension and violence. Chinese investors that took part in the China-Myanmar oil and gas pipeline project donated $4.07 million USD to Myanmar in 2011, and built 45 schools, 24 hospitals or medical centers, improving the healthcare environment for 800,000 people. However, civil society organizations like Shwe Gas Movement (SGM) announced publicly many times that local people did not benefit from this project and that the project lacked transparent and responsible finance management and corporate responsibility.

When distributing stakeholder benefits, companies should make use of stakeholder information gathered during consultations, taking consideration of the following questions: Does the current way of benefit distribution comply with the community's existing traditions? How is the benefit distribution decided? Who receives the benefits? Who does not? Who does the beneficiary represent? Do people believe that the benefit distribution is just? Is there any difference in understanding among different groups of people? How can the company guarantee that it will keep its promise? Will there be any record of company commitments? Do different groups of people get different compensation?

UNGC Guidance Case Two Asian companies in the heavy-manufacturing sector adapted products from its core earth moving range to remove anti-personnel mines in post-conflict areas. While working in one village, they learned that some villagers opposed mine-clearing activities. Villagers feared the government would appropriate cleared and safe land and claim it for commercial agriculture use. Even though a heavy manufacturing company was able to convert and extend their core business to support peace initiatives (mine clearance), unexpected negative impacts can arise, if companies neglect to analyze specific contexts thoroughly. The company widened the field of stakeholders and included more voices in its process of gathering information. As a result, the villagers put the land cleared of mines to beneficial use.

Companies should adopt a method for stakeholder consultation in order to ensure, to the greatest extent possible, that benefits are reasonably distributed across communities based on the communities' definition of fairness, not only to host communities as this can exacerbate tensions or increase competition. Fair benefit distribution can reduce conflicts between local groups.

CDA Case At an exploration project in Latin America, the local population consisted of a small number of landowners and a large landless population. To gain access to land, an extractives company was legally obligated to negotiate with landowners. A formal landowner's committee was invited to regular meetings with the company, which developed an engagement strategy that focused on the needs and expectations of landowners, and limited engagement with the landless population. Though the landless population did not expect to be consulted about land issues, it did expect the company to approach it as stakeholders whose needs and concerns were as valid as those of the landowners. Not being consulted about their needs or expectations, landless communities felt excluded from decisions that directly affected them. They were frustrated that the company's treatment of them was so different from its treatment of landowners. In fact, both the landless and the landowners in the community commented separately that the company's focus on the landowners created tensions between the two groups. Yet the company lacked an understanding of how communicating with all parties, and addressing their concerns were a necessary part of the project. Community relation's strategies the company created were driven exclusively by short-term company objectives that unintentionally put medium- and long-term company objectives at risk. Had the company engaged landless populations with the same level of timeliness, respect and importance, landless populations could have supported the long-term success of the project.

UNGC Guidance Case A major oil and gas project in Africa threatened to trigger violence between communities (which risked evolving into a company-community conflict) over employment, contracts and community projects. It was widely known that an exclusive focus on the nearby community would lead to further violent conflict instigated by those who felt left out. To respond, the company brought in an independent mediator to negotiate a benefit distribution agreement between all communities. The benefits distribution was based on: 1) population size; 2) ancestral ownership; and 3) disruption they would experience during construction due to proximity. Negotiation took place at three levels: 1) consultation with traditional leaders, 2) establishing principles of negotiations with three dominant communities, and 3) final negotiations with all stakeholders including all communities, the company, government representatives and contractors. As a result, the project was implemented without any conflict between communities or with the company. The project was completed with zero down days, and no community unrest.

3.8. Localization

Localization is a strategy. The essence of it is that transnational enterprises integrate different aspects of the business including production, marketing, management and human resources into the economic development of the host country. It is also a process of shouldering civic responsibility in the host country and integrating corporate culture into the local culture. Due to various reasons in the areas of policy, security, quality of personnel and cross-culture management experience, the extent of localization of Chinese enterprises in developing countries is far lower than the peers of developed countries, which has limited Chinese enterprises' ability to implement sustainable development in the local market. Also, Chinese enterprises have lost market opportunities because they cannot keep up with the changes and development of local situations.

Most of the middle and senior managers of Chinese overseas enterprises are sent directly from China rather than employed locally. In Cambodia, for example, local residents take less than 30% of the middle and senior management posts. Due to the shortage of local senior managers, it is more likely for social conflicts to arise because Chinese managers do not understand the local context. As a result, in Cambodia, labor unrest and strikes occur from time to time. This situation is better in Vietnam because Vietnamese nationals take up 63% of the engineering and middle or senior posts in Chinese enterprises operating in Vietnam.

Chinese overseas enterprises do not hire many local, blue-collar workers. According to statistics from February 2011 provided by the Ministry of Commerce, by the end of 2010, the total earnings of China's overseas labor force comes to $73.6 billion USD, while the value of contracts totals $76 billion USD. The total number of employees dispatched to work overseas was 5.43 million in the same year. These numbers did not include people who went overseas to work through private channels. A large number of Chinese employees traveling to work overseas can cause discontent in the host country. Chinese enterprises are also inclined to hire a large number of blue-collar employees on a part-time basis, which means the rights and welfare of these part-time employees cannot be guaranteed.

Chinese enterprises do not provide sufficient cultural awareness training to their employees. Assigned overseas, employees of Chinese enterprises often have limited knowledge about local religions, cultures and customs. Their interactions are often limited to circles of overseas Chinese and they fail to engage in the local mainstream society. Even worse, some Chinese workers look down on local cultures, communicating with chauvinism. Some Chinese workers and local residents have run into conflicts because of cultural differences. These problems could be alleviated if companies increase localization efforts. By employing more local people, the conflict risks of enterprises can be lowered. Extending local industrial chains, using local materials in supply, and engaging in local marketing and research could help. Enterprises better meet the demands of local consumers and the conditions of the local market.

Enterprises need to draw on and cultivate local people who are familiar with local culture and possess management abilities. This approach can reduce the chance of conflict as enterprises can benefit from the knowledge of local contexts and management styles. In some areas of investment, the level of education and technical training of local workers may not be as high as in China, but companies benefit by providing additional training to local hires, as workers and management team members.

Increasing local employment requires the reform of personnel management systems. Open recruitment of workers overseas can help to develop the company's international profile, and raise awareness of cultural differences and norms.

When developing resources overseas, Chinese enterprises should incorporate the skills and capacities of local mining and processing industries. This approach can facilitate transfer of expertise to host-countries and deliver greater economic benefits by lowering the cost of production and increasing their own competitiveness.

Many other business aspects, such as funding, research and development, corporate culture, material and marketing should also be localized. The corporate culture and practice in China cannot simply be copied and transplanted overseas. The names of many Chinese enterprises are not famous in the host country and local consumers are resistant to foreign-owned brands. Localized culture and practice can gain approval and recognition of local residents.

Chapter 4: Corporate Governance and the Culture of Chinese State-Owned Enterprises

Based on different types of ownership, there are generally four categories of enterprises in China – SOEs, collectively owned, private and foreign-funded.[55] This chapter focuses on SOEs, particularly the non-financial national SOEs[56] controlled by the State Owned Assets Supervision and SASAC,[57] because these national SOEs are the major players in China's overseas investment strategy, and represent the largest source of overseas investment. By the end of 2011, the total value of China's Outbound FDI (OFDI) reached $443.2 billion USD, the third largest in the world.[58] It is estimated that 85-90% of the investments have come from SOEs.[59] Most investment projects related to resource exploitation and infrastructure are implemented by national SOEs. Generally speaking, these types of projects are more likely to arouse conflicts with local communities. Because Chinese SOEs have some unique characteristics in governance structure and corporate culture when compared with private companies and SOEs in western countries, efforts to engage these SOEs on conflict management and peace building need to be informed by an understanding of their structures, operating principles and practices.

In China, SOEs usually refer to state-owned enterprises and state-holding enterprises, where the former are wholly state-funded firms, and the latter are firms whose majority shares belong to the government.[60] SOEs are under the control of the national, provincial or local governments, usually in accordance to their strategic significance and size. This chapter begins with a review of the reform history of SOEs since 1978. The author examines their relationship with the government after reform, such as changes to their management structure, and finally their role in the domestic and international economy.

4.1. Reform History of Chinese SOEs

4.1.1. SOEs Following the Establishment of the PRC (1949-1978)

After the establishment of the People's Republic of China (PRC) in 1949, all enterprises were nationalized. No private or international enterprises were allowed to operate in China. Some industries were not even operated by SOEs but by government agencies. For example, the

55 It usually refers to enterprises funded by township and village residents.

56 There are SOEs that owned by provincial and local governments.

57 Financial SOEs are supervised by China Banking Regulatory Commission, China Insurance Regulatory Commission or China Securities Regulatory Commission.

58 China Academy of Social Science, "China FDI Report 1st Season of 2013", 2013, http://www.iwep.org.cn/news/695910.htm

59 Development Research Center of State Council, "Capacity Building of SOEs' International Operation", 2013, http://www.sasac.gov.cn/n1180/n1271/n20515/n2697206/15476810.html

60 OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, "State Owned Enterprises in China: Reviewing the Evidence,"2009, www.oecd.org/dataoecd/14/30/42095493.pdf

Ministry of Petroleum was in charge of exploration and production of oil, until in 1988 it was transformed to CNPC. The SOEs bore little resemblance to modern enterprises. They were rather a production unit of the planned economy, as their sole function was to fulfill economic development plans produced by various levels of government. Usually the national government controlled SOEs with large assets and strategic importance. For example, First Heavy Machine Factory was responsible for producing heavy machines with both civil and military use.[61] Local governments ran small SOEs, which were more related to people's daily lives, such as textile factories. SOEs were also not allowed to keep profits. All profits were transferred to the government.

Because of their importance to the national economic plan, top officials of SOEs were selected from members of the Chinese Communist Party and appointed as government officials. There were no "managers" or "boards" but "directors" and "party committees." SOEs also received a high level of financial and political support from the government. These benefits included: government subsidies to offset enterprise losses; lifelong employment; state-pricing controls; easy access to bank credit; and monopolistic market practices.[62] While giving SOEs a tremendous advantage over any potential competitors, this support also contributed to tremendous economic inefficiencies.[63] Some benefits remain today, although they were reduced during the reform period.

4.1.2. SOEs and two Decades of Market Reforms (1979-1998)

The focus of this reform period is to return autonomy and profits to SOEs. Instead of giving all profits to the government, SOEs were allowed to keep some after-tax profits as an incentive for better performance.[64] By 1994, they were allowed to keep all after-tax profits. Meanwhile, the direct subsidy for capital investment was changed to a loan program run by China People's Bank of Construction.[65] As a result, many SOEs began to take on massive amounts of debt. In 1980, the asset-liability ratio of SOEs was a mere 18.7%. By 1994, this ratio reached a historical high of 79%.[66]

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61 It is the predecessor of China First Heavy Industries, a SOE under SASAC.

62 Jobs in SOEs are usually referred as "Iron Bowl (Tiefanwan in Chinese)" because of their stability and security. It is nearly impossible to lay off employees in SOEs.

63 Satya J. Gabriel, "Restructuring State-owned Enterprises in China," 1998, https://www.mtholyoke.edu/courses/sgabriel/soe.htm

64 Duanjie Chen, China's State-Owned Enterprises: How Much Do We Know? From CNOOC to its Siblings, 2013, http://www.policyschool.ucalgary.ca/?q=content/chinas-state-owned-enterprises-how-much-do-we-know-cnooc-its-siblings

65 It is the predecessor of China Construction Bank

66 Hui Wu, 1999, Reasons and Solutions for High Debt in SOEs, http://www.docin.com/p-573043471.html

Directors were given full control over the SOEs' operations, reducing the party's powers in business operations. Although granting SOEs certain autonomy, they still suffered from some flaws in management. Since there were no governance structures within SOEs to supervise their directors, SOEs could not hold directors accountable for business failure. Directors made decisions regarding personnel, finance, and business with little oversight. Corruption and mismanagement occurred more frequently as a consequence, with the overall performance of SOEs decreasing throughout this period.[67] In 1998, of 238,000 SOEs, 68.7% recorded losses.[68]

4.1.3. 1998-2007: Deep Restructuring

The emergence of private enterprises, as well as the arrival of the international companies brought unprecedented challenges to SOEs. These challenges only increased after China joined the World Trade Organization in 2001, introducing more foreign competition in sectors traditionally protected by the Chinese government, including financial institutions, telecommunications, automobiles, pharmaceuticals, and petrochemicals.[69] There was a pressing demand for deeper reform to increase competitiveness of SOEs.

The theme of this period is the corporatization of SOEs. Due to inefficiency and large debt of many SOEs, the central government decided to take a new strategy by "reinforcing the large SOEs while releasing the small ones," which aimed to consolidate and restructure large SOEs, while privatizing smaller SOEs. Large SOEs were given more autonomy in operations, while bankruptcies of a wide range of small SOEs were permitted, with assets of many more small SOEs sold off to both domestic and foreign buyers. Many SOEs were transformed into joint-stock enterprises, but with legal limitations on the percentage of private shares varying on an industry-by-industry basis. Large SOEs faced the greatest scrutiny when creating joint-enterprises. New corporate governance structures, including boards of directors, were established in order to modernize corporate operations. SOEs were also permitted to lay off employees in order to enhance operational efficiency. Meanwhile, forms of financing available to SOEs expanded, as new legislation allowed SOEs to be listed on domestic and international stock markets.[70] During the 2000s most SOEs under SASAC listed subsidiaries on stock markets.

67 Fang Chen, Law Weekend, June 26, 2013, http://opinion.hexun.com/2013-06-26/155516455.html

68 Shanguang, Kong, 2009, Reflections on costs and efficiency of SOEs' reform, http://frank.kong.blog.163.com/blog/static/245226320091020011167744/

69 David A. Ralston, Jane Terpstra-Tong, et al, "Today's State-Owned Enterprises of China: Are They Dying Dinosaurs or Dynamic Dynamos?" 2006, ufirc.ou.edu/publications/enterprises%20of%20china.pdf

70 Company Law and the Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies

Another key challenge for SOEs was ambiguity in their ownership and governance structures. A wide range of government agencies purported to have varying levels of administrative authority over the operations of SOEs. In the case of the municipal level SOE in the city of Guangzhou, Guangzhou Metro, approximately 15 government organizations were responsible for directing or overseeing part of its operations. These included the Construction Commission, Planning Commission, Finance Bureau, Price Bureau and Personnel Bureau. Administrative interference and a lack of clarity within the governance structure resulted in regular bureaucratic struggles over the direction of Guangzhou Metro's work.[71] For example, both the Finance Bureau and the Price Bureau had power over the fare price charged by Metro. The Construction Commission and the Planning Commission had jurisdictions over the route planning. However, none of these agencies were responsible for the ownership, gains or losses of the company, despite their control over key variables impacting profitability.

To clarify ownership and governance of SOEs, a new agency, State Owned Assets Supervision and Administration Commission was established in 2003 as a means of centralizing and streamlining state ownership and administration of SOEs. SASAC manages all the national non-financial SOEs, with its provincial and local branches managing SOEs belonging to the corresponding levels of government. SASAC is generally responsible for further corporatization of SOEs. By 2008, it released more than 100 guidelines and regulations regarding assets transfer, assets evaluation, performance management and financial supervision.[72] Executives of SOEs needed to agree with performance targets set by SASAC, and were awarded or punished according to their performance. SASAC recognized 64 assets transfer agencies as the legal institutions for transfer of state-owned assets.

4.1.4. Economic Stimulus and Rapid Expansion (2008-Present)

Large SOEs continue to grow in response to the strategy of "reinforcing the large SOEs while releasing the small ones." Because of the economic crisis in 2008, the Chinese government approved a stimulus package of $586 billion USD, with most of it invested in infrastructure. However, the investment mostly went to large SOEs.[73] Many SOEs used the money to acquire small enterprises and to invest in the real estate market. Such investment resulted in public criticism. The public believed it gave SOEs more advantages over the private

71 Edward Tse, "Transformation of a Chinese State-Owned Enterprise: Guangzhou Metro Corporation," 2006, http://www.booz.com/media/file/Transformation_of_a_Chinese_State-Owned_Enterprise_en_Booz.pdf

72 Ji Yu, 2008, Retrospect of SOEs Reform and Future Visions. Last modified Dec. 2013, http://china.findlaw.cn/gongsifalv/gongsidongtai/5460_2.html

73 China Economy Weekly, March, 2010, http://finance.qq.com/a/20100323/003237_2.htm

sectors. Most private enterprises already faced difficulties in seeking loans from commercial banks. Investments overwhelmingly flowed towards SOEs, only increasing the financial gap between SOEs and the private sector. Also, the investments exacerbated inflation and contributed to an unhealthy real estate bubble. The public demanded fewer privileges to SOEs, and more support for the private sector.

4.1.5. Result of the Reforms and Remaining Problems

These reforms helped SOEs reduce debts (asset-liability ratio was 64% in 2011, compared with 79% in 1994) and expand their assets (increased by 321% from 2002 to 2011). Some of them have become large enough to be on the Fortune 500 Global List. By 2011, 59.6% of about 136,000 SOEs made profits.[74] But it still left many problems unsolved. Many ambiguities remain around ownership and governances structures, with governments at different levels still retaining a large degree of control over SOEs. Governance structures resemble that of government agencies more than they do competitive enterprises. It is still very difficult to lay off employees in SOEs without evidence that they violated laws or party disciplines. Rarely are top executives recruited from outside of SOEs and governments. Government subsidies and pricing control remain strong in some strategic industries, such as the energy sector.

Since the government and the party still control SOEs' management personnel, SOEs have limited autonomy in developing their business strategies. The existing legislation only provides very general guidance for selecting and appointing top executives. Therefore, government officials and party members can actually choose executives at will, or maybe even personal preference. Some say this executive choice leaves SOEs open to nepotism and corruption.[75] The government's goal at present is making China's SOEs "bigger, stronger and superior" so as to expand globally and more rapidly.[76] Yet one of the SOEs' remaining important functions is to carry out the government's strategies and policies, regardless of what is needed as a business.

Since Chinese government actors need SOEs to carry out economic policies, they continue to provide generous financial support, even if state-owned banks ought to have more autonomy after reforms. Support includes financial grants, or indirect subsidies vis-a-vis

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[74] China Finance Year Book 2012. Last modified Dec. 2012, http://ishare.iask.sina.com.cn/f/64279610.html

[75] Jingfang Wei, Study on Legal Issue of Appointment of SOEs' Leaders, 2006, http://www.doc88.com/p-776496758196.html, p6

[76] Duanjie Chen, China's State-Owned Enterprises: How Much Do We Know? From CNOOC to its Siblings, 2013, http://www.policyschool.ucalgary.ca/?q=content/chinas-state-owned-enterprises-how-much-do-we-know-cnooc-its-siblings

low interest loans and favorable tax policies. China's renewable energy sector demonstrates the extent of Chinese subsidies. Since 2005, China has proclaimed a national policy to support and expand its solar and renewable energy industries. From 2010 to 2011, state-owned banks have provided more than $40 billion USD in preferential loans or credit to Chinese solar producers, an unprecedented amount even for China.[77]

SOEs still have many advantages over private enterprises, such as monopolies in strategic industries such as energy, mining, telecom and transportation sectors. The monopolistic position, and the inadequacy of transparency in operation and information disclosure, draws public criticism.[78] When strategic SOEs show windfall profits, people blame corruption. In 2012, five of the top 10 most profitable SOEs under SASAC were from the energy sector.[79] In 2013, the government started an anti-corruption movement, and more than 10 top executives of SOEs were arrested.

Although many national SOEs have earned profits after the reform, their efficiency remains a problem. Since 2007, the gap of Return On Assets (ROA) between SOEs and private companies has been expanding. In 2012, the ROA of SOEs was only 4.6%, while that of the private sector is 12.4%.[80]

4.2. Government Ownership of SOEs: The SASAC

4.2.1. Powers of SASAC as of early 2013

SASAC supervises 113 national non-financial[81] SOEs.[82] Adding up all of the subsidiaries of these SOEs and local SOEs, SASAC and its provincial and municipal branches are responsible for over 100,000 entities.[83] Directly above the SASAC is the State Council, chaired by the Premier. While the SASAC is responsible for most non-financial SOEs, note that around

77 Timothy C. Brightbill, Chinese State-Owned And State-Controlled Enterprises, Hearing Before the U.S.-China Economic and Security Review Commission, One Hundred Twelfth Congress Second Session, February 15, 2012, http://www.uscc.gov/Hearings/hearing-chinese-state-owned-and-state-controlled-enterprises

78 China Economic Times, Disclosure mechanism of SOEs' information should be improved (in Chinese), July 25, 2013, http://www.ce.cn/cysc/yq/dt/201307/25/t20130725_826185.shtml

79 SASAC website, http://www.sasac.gov.cn/n1180/n14200459/n14669156/

80 Neteasy, Nov 22, 2013, http://news.163.com/13/1122/08/9E98SGHL00014MTN.html

81 State-owned financial institutions were supervised not by SASAC but the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and China Securities Regulatory Commission (CSRC).

82 The list of these SOEs can be found on http://www.sasac.gov.cn/n1180/n1226/n2425/index.html

83 KPMG, State-owned entities: From centrally-planned origins to hybrid market competitors, June 2013, http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue9-201306-State-owned-entities.pdf

6,000 SOEs are still administered by the Ministry of Finance.[84] These include SOEs funded by different departments of the central government.

The power of SASAC is not clearly defined so far and it is struggling to establish its authority over SOEs.[85] Based on "Administration Law of Enterprises' State Owned Assets,"[86] SASAC has two noticeable authorities over SOEs: control over their top executives and management of the transfer of state-owned assets. For national SOEs under SASAC, top executives have to be appointed by SASAC, though all these executives must be reviewed and approved by the Organization Department of the Central Committee of the Communist Party. SASAC appointed executives normally include the chairman of the board of directors (usually also serving as the SOE's party chief), chairman of the board of supervisors, the CEO and chief financial officer (CFO). For SOEs wholly owned by the SASAC, it can also appoint other members of the board, and some senior executives such as the deputy CEO. The law also indicates that the SASAC can approve state assets transfers. However, even these decisions are subject to national and local governments approval.

4.2.2. Limitations of SASAC's Authority over SOEs

In practice, the role of SASAC remains ambiguous. The party, national and local governments can impose influence or even make decisions on many matters. Often times, local governments notify the SASAC branch as a formality after they select executives. The opinion of the branch does not carry much weight.[87] In many cases, SASAC even defers to the SOEs themselves. SASAC's location in the government organizational chart may contribute to this tendency. Although SASAC is a ministerial level agency, so are many of the most important SOEs under its supervision.[88] Other government agencies, such as the Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC), also have different influences over SOEs. For example, CNOOC has to sell all its crude oil to Sinopec and CNPC at the price set by the NDRC.

[84] China Economy Weekly, April 23, 2013, http://finance.people.com.cn/n/2013/0423/c1004-21239800.html

[85] Curtis J. Milhaupt, Chinese State-Owned And State-Controlled Enterprises, Hearing Before the U.S.-China Economic and Security Review Commission, One Hundred Twelfth Congress Second Session, February 15, 2012, http://www.uscc.gov/Hearings/hearing-chinese-state-owned-and-state-controlled-enterprises

[86] 中华人民共和国企业国有资产管理法

[87] Jingfang Wei, Study on Legal Issue of Appointment of SOEs' Leaders, 2006, http://www.doc88.com/p-776496758196.html, p5

[88] Li-Wen Lin and Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 2011, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623

The relationship between SASAC, its branches and local governments is equally complicated. In administrative structure, local SASAC branches are under the leadership of local governments. Meanwhile, it is also under the supervision of SASAC. Some cities do not have SASAC branches. Some have a very limited role in supervising state-owned assets and have conflicts with local governments. An example might be when the local government wants to expand local SOEs by increasing loans, while the SASAC branch wants to avoid large debts.[89]

The SOEs also share many personal ties with the party and the government. Usually most top executives of a SOE come from inside of the SOE or other SOEs from similar industries. Top executives from SOEs are also likely to be promoted to senior party or government positions, especially in cases where they meet the performance requirements regarding fulfillment of economic development plans and revenue targets set by government authorities. Government or party officials may also be moved to top executive positions of national SOEs, because many national SOEs hold ministerial level rank, and top executives share equal rank with government ministers (Table 4.1). For example, Jiang Jiemin, the director of SASAC (minister rank) who was charged with corruption in September 2013 was once the chairman of CNPC (minister rank). Before that, he held the deputy governor of Qinghai Province position, a vice minister rank. In addition, many positions in elite government and party bodies, such as the National People's Congress and the National Congress of the Chinese Communist Party (CCP) are usually held by leaders of the national SOEs, because of their important position in the national economy. For instance, in the 18th Congress of CCP in 2012, there were 145 representatives from enterprises. Among them, 111 were from SOEs and 52 from national SOEs.[90] Because of the connection between SOEs and governments, there is almost no open recruitment for top positions from domestic, private or international enterprises, except for some pilot recruitment organized by SASAC to fill a few senior positions (though none at the top).[91]

[89] China Economy Weekly, April 23, 2013, http://finance.people.com.cn/n/2013/0423/c1004-21239830.html

[90] China Economy Weekly, Nov 6, 2012, http://www.ce.cn/macro/more/201211/06/t20121106_23819792.shtml

[91] Hongxing Lu, Selection and Appointment of National SOEs' Leaders, 2005, http://www.doc88.com/p-115719254821.html, p.32

Table 4.1 Leader Rotations in the Chinese national SOEs[92]

Year	Leader Rotations				
	Between national SOEs	From national SOEs to government/party	From government/party to national SOEs	From local SOEs to national SOEs	Total rotations
2004	27	6	13	0	46
2005	27	5	14	0	46
2006	20	3	10	1	34
2007	33	7	16	0	56
2008	NA	NA	NA	NA	50
2009	NA	NA	NA	NA	27

* Leaders including members of the board, CEOs, vice CEOs, chief accountants, chiefs and deputy chiefs of SOEs' party committee, secretaries of party's discipline inspection committee.

** Data Source: China's State-owned Assets Supervision and Administration Yearbooks 2005, 2006, 2007, 2008, 2009, and 2010.

4.3. Architecture of SOEs

All of the 113 central level SOEs under SASAC have numerous subsidiaries. As such, the official names of these SOEs generally include the words "Group" or "Corporation" to identify their status as major state-owned holding companies. Chinese SOEs are generally made up of the following four key components:[93]

(1) Core (Parent) company: At the highest administrative level is the parent or core group company, whose shares are ostensibly wholly-owned by SASAC. Historically, such core companies were typically formed when a government ministry with jurisdiction over a particular industry was corporatized through the process of reform in the 1990s. For example, each of the core companies in the national petroleum groups was formerly a component of the once Ministry of Petroleum, and is now a limited liability, corporate entity with, a board of directors, and shares held by a SASAC. The core company serves as an intermediary between SASAC, other government agencies (e.g. NDRC, MOFCOM) and its numerous subsidiary firms, which actually engage in economic activities. The core company

[92] Li-Wen Lin and Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 2011, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623

[93] Li-Wen Lin and Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 2011, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623

coordinates information flows and resource allocations within the group. It transmits policy downward from the state to group members, and provides information and advice upward from the group to state economic strategists and planners.

Internal group governance structures are specified in a legally binding agreement called Articles of Grouping, which is adopted by all members.[94] The Articles are state-supplied standard form contracts required of all registered business groups, but their specific provisions are largely composed of default rules. In reality, the core company dictates the terms of the Articles, and the internal governance rules grant it veto rights and other enhanced governance rights with respect to the group. Many articles provide for plenary or management bodies to facilitate group or delegated decision making, respectively, but these organs typically either have only advisory power or are structured so that the core company effectively controls their decision-making processes. In short, governance in a Chinese business group is a largely, top-down process, but one that is open to information and participation from below.

(2) Listed company: One aim of the corporatization reform is the diversification of investors. Since then, most core group companies have some of their subsidiaries listed. The minority of their shares is publicly traded on either the Chinese or Hong Kong stock exchanges and often on other major exchanges as well. For example, PetroChina, one of the largest oil companies in the world, whose shares are listed on the Shanghai and New York Stock Exchanges, is part of the China National Petroleum Corporation.

(3) Finance company: One of the key benefits of registering, as a corporate group is eligibility to establish a financial services company. Such finance companies raise capital for group members, and are exempt from the general prohibition in Chinese law on inter-company lending. Under the current legal framework, a finance company provides services on behalf of group members similar to those of commercial or investment banks. Subject to approval by banking regulators, they are authorized to engage in a wide range of activities, including accepting deposits from and making loans to member companies, providing payment, insurance, and foreign exchange services to members, and underwriting the securities of member firms. They also engage in consumer finance related to the products of group

[94] An example from China Datang Corporation, http://hvdc.chinapower.com.cn/membercenter/sitebuild1/otherfront.asp?user=dtpower&target=column&columnid=103

members, and invest in securities issued by financial institutions. Deposits from group member companies are their main source of funds. Almost all finance companies are members of state-owned groups, either at the national or provincial level, and many are formidable in size.

The creation of non-bank finance companies within business groups (or what one commentator has called "outside the plan financial intermediaries") poses an obvious competitive threat to a largely state-owned commercial banking sector. As such, Chinese regulators have been vigilant about not expanding the scope of finance company activities to the point that they constitute a complete substitute for Chinese commercial banks, which remain an important source of funding for SOEs. The size of top finance companies is shown in Table 4.2. The largest one is comparable to the 20th largest commercial bank in China.

Table 4.2 Top 10 Finance Companies in China, by Asset Size, 2009[95]

Rank	Company Name	Asset ($ Billion USD)	Bank with Comparable Asset Size (National Rank)
1	China Petroleum Finance Co.	40.87	Beijing Rural Commercial Bank (20)
2	China Power Finance Co.	16.46	Shengjing Bank (36)
3	Sinopec Finance Co.	8.31	Bank of Hebei (52)
4	China Ship Building Industry Finance Co.	6.85	Bank of Nanchang (57)
5	SAIC Finance Co.	6.43	Bank of Qingdao (58)
6	China Aerospace Science & Tech. Finance Co.	4.56	Bank of Weifang (79)
7	CNOOC Finance Co.	4.44	Qishang Bank (82)
8	Haier Group Finance Co.	3.64	Kunshan Rural Commercial Bank (93)
9	China Power Investment Finance Co.	3.55	Chang'An Bank (95)
10	WISCO Finance Co.	3.27	Bank of Jujiang (96)

95 Li-Wen Lin and Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 2011, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623

(4) Research Institutes: Chinese policymakers encourage business groups to include research institutes as members to promote technology development, and increase international competitiveness. Most of the national business groups contain one or more research institutes. The research institutes conduct R&D, particularly applied research in areas related to the group's products and production processes. Often, the research institutes collaborate with universities on particular projects to derive complementarities between the applied focus of business R&D programs and the theoretical approach of academic researchers. Typically established as not-for-profit institutions, the research institutes receive funding from the core company in the group.

China Datang Corporation is a typical example. It is one of the five largest power-generating SOEs, which previously made up the Ministry of Electricity. It owns four listed companies, with Datang International Power Generation Co. Ltd. (DIPG), being the largest one, and listed in London and Hong Kong. DIPG and the Corporation share the same chairman and many other top executives. Board members of the corporation are also top executives of the other three listed companies. In 2010, Datang Finance Co. Ltd. held assets of about $ 2.2 billion USD. It has two research institutes: Datang Research Institute of Technology and Economy and Datang Research Institute of Technology and Economy.[96] The former focuses on energy technology and the latter on energy policy and strategy.

4.4. Management of SOEs

After the 1998 reforms, many governance and oversight institutions, including boards of supervisors, boards of directors, general executives, and boards of shareholders were established in SOEs. However, most members of the board and executives are appointed from inside the SOEs or government agencies. Such appointments make it nearly impossible for the board to supervise executive conduct or performance, not only because the board lacks power to appoint managers, but also because of the tight relationships linked within the ministries, political parties and inner circles of the organization's leadership structure. Moreover, some SOEs and their subsidiaries share the same members of the board. For instance, CNOOC and its listed subsidiary CNOOC Ltd. always share a majority of board members (five of the six in 2011) including the chairman of the board.[97]

[96] Datang Official Website, last modified Dec. 2013, http://www.china-cdt.com/aboutdatang/memberenterprise/index.html
[97] Duanjie Chen, China's State-Owned Enterprises: How Much Do We Know? From CNOOC to its Siblings, 2013, http://www.policyschool.ucalgary.ca/?q=content/chinas-state-owned-enterprises-how-much-do-we-know-cnooc-its-siblings

Aside from management of top executives, human resource management inside most national SOEs has been changed after the reform. Most SOEs historically emphasized technical skills in hiring, so that 60-70% of personnel were technical staff. But as they open themselves up to competition, they realized a real shortage of talent in sales, customer service and marketing.[98] The need has driven the traditional personnel management to change into human resources management. But some problems remain, such as a rigid management system, lack of performance management and flat wage scales. For example, all employees with the same educational background and the same number of years of service enjoy the same wage or even bonus regardless of performance. Also in China, SOEs need to balance commercial and social responsibilities imposed by the government, including government imposed hiring quotas. While companies often work to reduce their total workforce to increase efficiency, the government often rejects proposed personnel changes. It views layoff of redundant and inefficient staff of SOEs as risky, because the government wants to protect those who may have difficulty finding a new job. Social stability and fears that the country's young social security system will not be able to provide for these workers, remains a large concern for the government. If large numbers of government employees become dissatisfied, they may take to the streets in protest.

Despite flaws in management, the average payment to national SOEs' employees is better than most domestic private companies and comparable to international companies operating in China. According to the latest data, the average annual wage for employees of 287 national SOEs and their subsidiaries in 2012 was ¥111,357 RMB, three times of the domestic private sector.[99] Moreover, SOEs' employees enjoy other non-wage benefits, such as allowances for holidays and reimbursement for daily transportation. About 20 years ago, many of China's workers aspired to work for international employers. Now in a survey of the 50 best employers in China, only 18 listings were from foreign companies, while the rest were Chinese companies, mostly national SOEs. National SOEs are popular because they are also thought to weather economic downturns without incurring massive layoffs.[100]

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[98] Mercer, Transforming human capital management in state-owned enterprises, 2008, http://www.mmc.com/knowledgecenter/BT-SOEs.pdf

[99] Netease Lab, National SOEs Wage Report, 2012, http://money.163.com/special/wage_report2012/

[100] KPMG, State-owned entities: From centrally-planned origins to hybrid market competitors, last modified June 2013, http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue9-201306-State-owned-entities.pdf

4.5. SOEs' Power in Domestic Economy and Their Global Expansion

Although SOEs still control many resources important to the national economy, their share of national Gross Domestic Product (GDP) has declined substantially since 1978. In 1978, it was reported that SOEs represented 78% of overall industrial production.[101] In 2004, the share was estimated to be around 34%.[102] SOEs appear to have retreated from the more competitive and more labor-intensive industries, maintaining less than 10% of industrial output in sectors such as textiles, leather, fur, timber, wood, furniture, paper and printing.[103] The number of SOEs was reduced after the reform. SOEs numbered 262,000 in 1997,[104] only to decrease to less than 160,000 by 2012.[105]

Although SOEs' share of the economy is declining, SOEs still play a dominant role in strategic industries, such as petroleum, transportation, mining and electricity. Moreover, the power of national SOEs has been consolidated and expanded, mainly due to buy-outs of small and medium-sized SOEs. Especially after the economic crisis in 2008, a majority of $600 billion USD stimulus of government funds and bank loans flowed to SOEs.[106] From 2002 to 2011, the assets of national SOEs have increased from ¥7.13 to ¥28 trillion RMB.[107] Their revenue has grown from ¥3.36 to ¥20 trillion RMB. Some 40 national SOEs under SASAC were on the list of Fortune Global 500 in 2012.

SOEs actively started to internationalize after the CCP initiated the "going-out strategy" as part of the 10th "Five-Year Plan" in the year 2000. The strategy means "in a practical sense that the government supports and encourages globalization of enterprises. But at a political level, it means that government economic policy takes into account international issues, like regional free trade agreements and natural resource development projects abroad, such as funding oil exploration in Africa."[108]

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101 OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, "State Owned Enterprises in China: Reviewing the Evidence,"2009, www.oecd.org/dataoecd/14/30/42095493.pdf

102 Xinhuanet, July 8, 2004, http://news.xinhuanet.com/fortune/2004-07/08/content_1584716.htm

103 OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, "State Owned Enterprises in China: Reviewing the Evidence,"2009, www.oecd.org/dataoecd/14/30/42095493.pdf

104 Ibid

105 National Bureau of Statistics of China, China Statistics Year Book, 2013

106 David F. Gordon, Chinese State-Owned And State-Controlled Enterprises, Hearing Before the U.S.-China Economic and Security Review Commission, One Hundred Twelfth Congress Second Session, February 15, 2012, http://www.uscc.gov/Hearings/hearing-chinese-state-owned-and-state-controlled-enterprises

107 People's Daily, April 12, 2012, http://finance.qq.com/a/20120412/001520.htm

108 OECD Working Group on Privatisation and Corporate Governance of State Owned Assets, "State Owned Enterprises in China: Reviewing the Evidence,"2009, www.oecd.org/dataoecd/14/30/42095493.pdf

Since this strategy was announced in 2000, Chinese government organizations have released a growing number of related policies.[109] Many central government agencies have been involved in the policymaking process including MOFCOM, NDRC, SASAC, State Administration of Foreign Exchange (SAFE), Ministry of Finance (MOF), People's Bank of China (PBC) and China Securities Regulatory Commission (CSRC). Their major responsibilities about China's OFDI are summarized in Appendix 4.2. Most of these policies were designed to boost overseas investment by providing financial support and streamlining procedures. As investments grow rapidly and some negative impacts emerge, more regulations and policies are developed to hold overseas investors accountable financially, socially and environmentally. The most important policies regarding social and environmental impacts are summarized in Appendix 4.3.

4.6. Conclusion

Chinese SOEs have been through many changes since 1978. Most small SOEs have been privatized or bought out by larger SOEs. Meanwhile, large national SOEs have consolidated their power and expanded rapidly across the globe. Because the Chinese government expects globalization can make SOEs more competitive, and can help China gain access to resources and technologies necessary to future economic transformation and development, there is no doubt that in the long run, China's overseas investment will continue to grow.

Despite many efforts made by the government, challenges remain. The corporatization and management of SOEs are still a work in progress. Meanwhile, globalization of SOEs has encountered many problems and conflicts, because of their flawed structure and management style. As mentioned in previous chapters, they do not have experience or institutions for public consultation, localization, and compliance. Fortunately, more and more government and SOEs' leaders have realized the problem. For example, officials in SASAC stated occasionally that the "going-out" strategy should use more international talents, and pay more attention to human resource development.[110] SOEs will provide more training to their employees in dealing with problems overseas.

The private sector in China is growing fast, and also has started its own "going out strategy." However, in overseas investment, national SOEs are still the dominant player, because of

[109] The reasons for China's enthusiasm of overseas investment are discussed in Chapter 2 of this book.

[110] Beijing Youth News, June 30, 2010, http://news.stockstar.com/JL2010063000001532.shtml

the continued financial and political support from the government. China's overseas investment concentrates on resources and infrastructure, where SOEs hold monopolies in China, and have sizable assets geared for large-scale investment. As long as China's investment will continue to be centered on resources and infrastructure, SOEs will remain as prominent and important global players.

The future reform agenda set by the 18th Congress of Chinese Communist Party in November 2013 aims to further corporatize and modernize SOEs, and open more strategic industries to the private sector for competition. The environmental pollution in China and conflicts in overseas investment have increasingly attracted attention from international political leaders and the Chinese public. The idea of compliance and corporate social responsibility is spreading through policy-makers, scholars and business people.

Forecasts predict that China's overseas investment will reach $150 billion USD by 2015.[111] Therefore, there will be more demands for China's investors to behave in a more socially- and environmentally-friendly way. Yet the mechanisms to ensure compliance with social and environmental regulations by Chinese investors are still being developed. Many Chinese government agencies and think tanks are working on projects related to overseas investment and legislation, anticipating more opportunities for Chinese governments and CSOs to engage internationally.

[111] Nathalie Bernasconi-Osterwalder, Lise Johnson, and Jianping Zhang, Chinese Outward Investment: An emerging policy framework, www.iisd.org/pdf/2012/chinese_outward_investment.pdf

Appendix

Appendix 4.1 CHRONOLOGY OF CHINA'S SOE-SECTOR REFORM OR CHANGE (1949-2014)[112]

Year	Existing Condition, or Reform Event, Reference (and website) or Policy Change
Pre-1979	SOEs fully controlled by the government. The SOEs were actually named as state-run enterprises (guoying qiye) since the government took all profits while funding all capital investment and operational expenses (tongshou tongzhi).
1979-	SOEs become semi-autonomous entities as a result of the government's granting autonomy to and sharing profits with SOEs (fangquan rangli). Also starting in 1979, the government gradually replaced previous direct funding with bank lending (bo-gai-dai) to SOEs for capital investment and operational expenses.
1983-1984	SOEs gained partial financial autonomy as a result of a policy switch, which converted remitting profit to paying tax to the government (li-gai-shui). Tax rates were 55% for large and medium-sized firms, and a portion of their after-tax profit to the government was remitted. An eight-tier progressive tax scale (ranging from 10% to 55%) for small firms, allowed small firms to retain in control of their after-tax profits.
1987-	A new contract system allows SOE managers full control of business operations (chengbaozerengzhi and/or changzhang fuzezhi).
1994	SOEs largely exempted from remitting after-tax profits to the government, as a result of a State Council decision; this introduced new incentives to generate profit.
1995-	Restructuring begins. The government supports the SOE sector by "reinforcing the large SOEs, while releasing the small ones" (zhuda fangxiao), and establishing the "modern enterprise system through corporatization (including implementing modern accounting standards) and market capitalization."
1999	Reforms made to SOEs' ownership and capital raising. Profitable SOEs are partially listed on stock exchanges both overseas and domestically, according to the Company Law and the Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies on November 5, 1999.
1999	SOEs are given special status in operating businesses that concern national security, natural monopoly, important public goods and services and "key enterprises" in "pillar industries" and high-tech industries.
2003	SASAC established to manage all central government owned, non-financial SOEs. SASAC represents the State Council, or owner of all SOEs. Another layer of sub-national SASACs manage SOEs belonging to the corresponding levels of government.
2006	Head of SASAC declared the state retains absolute control of seven industries, including defense, power generation and distribution, petroleum and petro-chemicals, communications, coal, airlines, and water transportation in SASAC's "Guidance on Restructuring State-Owned Assets and Enterprises." The state dominates (strongly controls) industries related to equipment manufacturing, autos, electronic communications, construction, steel, non-ferrous metal, chemical, geologic survey and design, and science and technology.

[112] Duanjie Chen, China's State-Owned Enterprises: How Much Do We Know? From CNOOC to its Siblings, 2013, http://www.policyschool.ucalgary.ca/?q=content/chinas-state-owned-enterprises-how-much-do-we-know-cnooc-its-siblings

2009	The State Council introduced a revitalization program for 10 vital industries, including steel, autos, ships, petrochemicals, textiles, light manufacturing, non-ferrous metals, equipment manufacturing, electronic products and transportation and storage. A main component of the revitalization program supported and encouraged industrial reorganization through mergers and acquisitions by large and strong firms, of which most are SOEs.
2014	SASAC selected a few SOEs to implement several important reforms on a trial basis: 1) Change some SOEs into State Owned Asset Management Enterprises; 2) Allow private investors to hold share of SOEs; 3) Grant Boards of Executives more power in supervising management; 4) Party Discipline Committee will send personnel to SOEs on a long term basis as an anti-corruption measure.

Appendix 4.2 Major Responsibilities Regarding Overseas Investment[113]

Agency	Major Responsibilities
Ministry of Commerce	• Supervising OFDI by drafting and implementing policies and regulations, and by considering applications for approval of non- financial OFDI projects; • Negotiating bilateral and multilateral investment and trade treaties, and representing China at the World Trade Organization and other international economic organizations; • Aligning China's economic and trade laws with international treaties and agreements; and • Coordinating China's foreign aid policy and other related funding and loan schemes.
State Administration of Foreign Exchange	• Reporting balance of payments data to the State Council and the International Monetary Fund; • Recommending foreign exchange policies to the People's Bank of China; • Overseeing the transfer of foreign exchange out of and into China under the capital account of the balance of payments; and • Managing China's foreign exchange reserves.
National Development and Reform Commission	• Regulating government investments in domestic industries and developing strategies, goals and policies to balance and optimize China's overseas investments; • Issuing guidelines concerning access by domestic firms to soft loans to finance their internationalization; • Publishing a host country catalogue that lists the countries in which the Chinese government subsidizes OFDI projects, done in cooperation with MOFCOM; • Collaborate with other ministries to approve large scale Chinese OFDI projects, including: Large-scale Chinese OFDI projects in industrial sectors such as natural resources, or projects involving large sums of foreign exchange.

[113] Huang Wenbin and Andreas Wilkes, "Analysis of China's overseas investment policies," 2011, http://www.cifor.org/publications/pdf_files/WPapers/WP-79CIFOR.pdf

Ministry of Finance	• Drafting development strategies, plans and policies for China's fiscal and taxation sectors, and cooperating in the development of macro-economic policies based on forecast economic trends; • Drafting laws and regulations regarding fiscal, taxation and accounting management; • Managing the central government's revenue and expenditures, including preparing the annual budget, supervising its use and reporting to the central government; • Negotiating agreements regarding China's overseas fiscal activities, such as debt.
People's Bank of China	• The PBC is responsible for overall financial policies and rules, and for dealings with international financial organizations, such as the World Bank. It also supervises and manages China's foreign exchange reserves.
China Securities Regulatory Commission	• In relation to China's OFDI, it is responsible for approving and supervising Chinese companies' overseas stock issues and debenture activities, stock market listings and related financial activities.
State Owned Assets Supervision and Administration Commission	• SASAC's objective as an investor is to ensure that the SOEs under its supervision remain competitive and increase their profitability and the value of the assets under their control. OFDI projects by state-owned companies under the supervision of SASAC are unlikely to be decided without the explicit approval of SASAC.
Export-Import Bank of China	• This ExIm Bank is expected to operate on a breakeven basis and is at the center of the "Going out" strategy. It provides export seller's credits (large, preferential loans for Chinese companies operating abroad); export buyer's credits (loans to importers of Chinese goods or services in targeted sectors). It also provides guarantees, and operates China's program of concessional foreign aid loans. The concessional loan program is the only aid program it operates. Its other offerings – export credits and guarantees– are not counted as aid and make up the bulk of its portfolio.
China Development Bank	• It works with the ExIm Bank to support Chinese companies' major projects abroad. As of 2009, it was active in 78 countries, implementing and promoting the "Going out" strategy through such offerings as currency swaps, credits and loans, fund management, equity investment, merger and acquisition financing, and leasing operations. Its overseas activities cover infrastructure, basic industries, agriculture, small and medium-sized enterprises, and housing.
Ministry of Environmental Protection	• Drafting policies related to environmental protection; • Setting technical standards for environmental evaluation and protection; • Conducting EIA for major development plans; • Coordinating cooperation with international communities on environmental issues.

Table 4.3 Policies and Regulations of Overseas Investment Regarding Sustainable Development[114] [115] [116]

Date	Agency	Policy	Description
2002	Ministry of Foreign Trade and Economic Cooperation and State Administration of Foreign Exchange	Temporary method for annual inspection of overseas investments 《境外投资联合年检暂行办法》	Enterprises are given an evaluation score. Companies which do not to pass the evaluation are deprived of their concessionary benefits, such as credit and special fund support. In 2009, recipient countries' issues were taken into consideration and accounted for 20% of the company's total evaluation score. About 10% of points are deducted if a company violates local laws and is penalized by the recipient country. The same percentage of points is also deducted for any quality, safety, environmental or labor problems or conflicts.
2006	Ministry of Environmental Protection and People's Bank of China	Circular on sharing information on corporate environmental issues 《关于共享企业环保信息有关问题的通知》	Imported environmental information on companies into the Basic Company Credit Database that is used by banks and the financial regulatory agencies in credit application reviews. The circular laid out the foundations for 'green finance.'
2007	Ministry of Environment Protection and People's Bank of China and China Banking Regulatory Commission	Opinion on implementing environmental protection policies to prevent credit risk 《关于落实环保政策法规防范信贷风险的意见》	Required banks to control provision of credit to unqualified companies and companies that violated environmental laws. It suggested making use of credit measures to protect the environment.
2007	China Banking Regulatory Commission	Opinion on strengthening the social responsibility of financial institutions 《关于加强银行业金融机构社会责任的意见》	Requires large banks to fulfill their social responsibility obligations by adhering to the 10 principles of the UN Global Compact.
2007	State Forestry Administration	Guide on Sustainable Overseas Silviculture by Chinese Enterprises 《中国企业境外可持续森林培育指南》	Requires preservation of high-value forests and endangered species, monitoring systems, and consultations with local communities.

[114] Denise Leung and Yingzhen Zhao, "Environmental and Social Policies in Overseas Investments: Progress and Challenges for China,"2013, http://www.wri.org/publication/environmental-and-social-policies-overseas-investments

[115] Huang Wenbin and Andreas Wilkes, "Analysis of China's overseas investment policies," 2011, http://www.cifor.org/publications/pdf_files/WPapers/WP-79CIFOR.pdf

[116] Nathalie Bernasconi-Osterwalder, Lise Johnson, and Jianping Zhang, Chinese Outward Investment: An emerging policy framework, www.iisd.org/pdf/2012/chinese_outward_investment.pdf

2007	Export-Import Bank of China	Guidelines for environmental and social impact assessment of the China Export and Import Bank's (China EXIM Bank) loan projects 《中国进出口银行贷款项目环境和社会影响评价指导意见》	At the core of the guidelines are three main activities: prior review, process oversight and post review. Each includes an evaluation of environmental and social impacts on loan projects.
2007	State-Owned Assets Supervision and Administration Commission	Guidelines to the State-owned Enterprises Directly Under the Central Government on Fulfilling Corporate Social Responsibilities 《关于中央企业履行社会责任的指导意见》	Defines the principles and scope of Corporate Social Responsibility, and recommends some ways to implement it.
2008	Ministry of Commerce, Ministry of Foreign Affairs and State-Owned Assets Supervision and Administration Commission	Circular to regulate the overseas investment and cooperation of Chinese companies 《商务部、外交部、国务院国有资产监督管理委员会关于进一步规范我国企业对外投资合作的通知》	Companies that violate laws and regulations, causing serious incidents in the recipient country are penalized by MOFCOM, MFA and SASAC.
2009	State Forestry Administration and Ministry of Commerce	Guide to Sustainable Overseas Forest Management and Utilization by Chinese Enterprises 《中国企业境外森林可持续经营利用指南》	Guides the overseas activities of Chinese enterprises in forest management. It regulates how companies use, protect, and attempt to contribute to sustainable development of global forest resources. It also regulate how Chinese enterprises process and use wood-in foreign countries, in efforts to improve their self-regulation, promoting legal and sustainable global forest resources and related trade activities.
2009	Ministry of Commerce	Management measures of overseas investment （中华人民共和国商务部令2009年第5号 《境外投资管理办法》）	Requires companies to comply with the laws and regulations of investment destinations and to consider social responsibility when conducting their business affairs.
2011	Export-Import Bank of China	Environmental Assessment Framework 《环境影响评价框架》	Building on guidelines and best practices of World Bank and Asian Development Bank, the ExIm Bank revised its own policies for all

		Resettlement Policy Framework 《移民安置政策框架》	overseas projects it supports. The two documents were originally designed for domestic projects related to the 'Energy Efficiency Financing III Project,' funded by the World Bank. The same type of approach is also used for the financing projects abroad in other sectors, such as infrastructure projects.
2011	State-Owned Assets Supervision and Administration Commission	Interim Measures on the Supervision and Administration of the Overseas State-owned Assets of Central Enterprises 《中央企业境外国有资产监督管理暂行办法》 Interim Measures on the Administration of the Overseas State-owned Property Rights of Central Enterprises 《中央企业境外国有产权管理暂行办法》	This supervision system provides the most direct influence over SOEs and can oversee the environmental and social issues arising from overseas investments.
2012	State-Owned Assets Supervision and Administration Commission	Interim Measure for the Supervision and Administration of Central SOEs' Overseas Assets 《中央企业境外国有产权管理暂行办法》	This commission oversees the environmental and social issues arising from overseas investments.
2012	China Banking Regulatory Commission	Green Credit Guidelines 《绿色信贷指引》	Establishes guidance for Chinese banks financing overseas activities, including transparency, monitoring, and supervision.
2013	Ministry of Commerce and Ministry of Environment Protection	Guidelines on Environmental Protection for Overseas Investment and Cooperation 《对外投资合作环境保护指南》	Requires all Chinese companies operating overseas to conduct environmental impact assessments, develop mitigation measures, and work with local communities to identify potential negative impacts of the investment.
2013	Ministry of Commerce, Ministry of Foreign Affairs, Ministry of Public Security, Ministry of Housing and Rural-Urban	Interim Measure for Poor Credit Record in Overseas Investment Cooperation and Trade 《对外投资合作和对外贸易领域不良信用记录试行办法》	Requires relevant government agencies to collect and publish illegal activities of overseas companies.

	Development, General Administration of Customs, State Administration of Taxation, State Administration of Industry and Commerce, State Administration of Quality Supervision and Inspection and Quarantine, State Administration of Foreign Exchange		
2014	Ministry of Commerce, China Chamber of Commerce of Metals, Minerals, & Chemicals Importers & Exporters	Guidelines on Social Responsibility in Outbound Mining Investments 《中国对外矿业投资行业社会责任指引》	Overview of the CSR process involved in mining investments and guidance on how to implement CSR projects.

Supplement

PREVENTING CONFLICT IN EXPLORATION

A Toolkit for Explorers and Developers

PDAC

CDA COLLABORATIVE LEARNING PROJECTS

World Vision

Government of Canada
Trade Commissioner Service

Gouvernement du Canada
Service des délégués commerciaux

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About the Toolkit

This Toolkit has been developed collaboratively by the Prospectors and Developers Association of Canada (PDAC), World Vision Canada, and The Corporate Engagement Program - CDA Collaborative Learning Projects, and supported by the Department of Foreign Affairs and International Trade – Canada.

The Toolkit is intended as a simple and practical guide, providing key steps for preventing conflict through constructive community engagement in exploration. The Toolkit draws from the tools of the collaborating partners, including the Corporate Engagement Program Framework, PDAC's e3Plus, and World Vision's Making Sense of Turbulent Contexts. The Toolkit also draws its content from a series of field tests with exploration companies as well as the input of many contributors and collaborators. Their contributions are acknowledged therein.

Users wanting more guidance on stakeholder engagement, conflict prevention, and risk/impact assessment should refer to the Resource Pack contained in this Toolkit.

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FOREWORD

Many multi-national mining exploration and development companies operate in areas suffering from violent conflict and chronic instability. Control and access to the resources that they seek to extract are often key drivers of conflict and instability. Not surprisingly then, tensions sometimes escalate when extractive operations commence. However, this is not inevitable, and companies themselves can do much to mitigate the emergence of these tensions, even during the early exploration phases.

In the last decade, the extractive industry has undergone significant changes in the way it interacts with its stakeholders, shareholders, and the physical, social, and political environment. Extensive international guidelines have emerged in response to the growing demand for good governance, transparency and accountability on the part of corporations: the International Finance Corporation's Performance Standards, the Equator Principles, and the Extractive Industries Transparency Initiative to name a few. The industry's movement in this direction is evident in the commitments and pledges of exploration and mining companies to these important international structures and processes.

The private sector is also increasingly recognized as a development actor with a legitimate interest and a key role to play in achieving global commitments to sustainable development, such as the UN Millennium Development Goals (MDGs). Many companies are already implementing successful strategies to bring mutual and sustainable benefits to local stakeholders while simultaneously achieving stable corporate operations. Communities expect the former; shareholders demand the latter. Building capacity for responsible community engagement and conflict-sensitive mining is, therefore, a strategic interest for all parties.

Where the gap remains is in realization of these global commitments at the community level – where exploration and mining projects have the most tangible impact and yet, where companies often lack expertise in effective community engagement. Despite notable progress in implementing constructive and conflict sensitive engagement strategies with local communities, the gaps between good intentions and implementing good practices has remained wide. Local communities continue to bear the brunt of this failure. Publication of Preventing Conflict in Exploration is therefore timely. It aims to fill one of these gaps by providing a simple but robust conflict-sensitivity tool for use by prospectors and other exploration staff who often represent the first point of contact between the company and the community.

Preventing Conflict in Exploration is itself the product of an innovative collaboration between the Prospectors and Developers Association of Canada (PDAC) and two non-profit organizations, CDA Collaborative Learning Projects and World Vision Canada, with funding support from the Government of Canada - Department of Foreign Affairs and International Trade (DFAIT). It represents an important convergence of mutual interests, shared responsibility and joint learning. Hopefully, it will encourage similarly respectful and beneficial collaborations in locations where it matters even more – prospective and actual mining sites around the globe.

CONTENTS

INTRODUCTION

Preventing Conflict in Exploration: A Toolkit for Explorers and Developers (PCE) presents a simple and practical analysis Tool that helps mining exploration and development companies approach their routine business activities in a manner that furthers positive relations with local communities, even where tensions or conflict exist in the local operating environment.

Conflict sensitivity in exploration activities is achieved through engagement that is early, ongoing, broad and inclusive, beginning in exploration and continuing throughout the project lifecycle. The PCE Tool guides explorers and developers in scanning the social, political and economic environment in order to effectively identify key stakeholders, conflict risks and opportunities for intervention for the purpose of building conflict sensitive engagement strategies.

> **Tip**
> **PCE** is presented as a Toolkit of resources, including a pull-out Tool that you can take into the field with you.

A project **Stakeholder** is anyone who can affect or may be affected by the project. Stakeholders can include communities, civil society organizations, regional and national organizations, and government offices and agencies, among others.

This Tool will focus on **Local Communities** that are impacted, directly or indirectly, by exploration activities. **Community Engagement** is the consultation and communication practices employed by the company for the purpose of building relationships with local communities.

Developers and exploration teams are the first face of any exploration project. Their actions establish expectations within communities that can have long-term implications for future relations. However, many explorers express that they lack the skills to address social issues and would welcome exploration-specific guidance. Engagement is often approached on an ad hoc basis, relying on the limited information collected by geologists who lack time and resources, or on small community relations teams with limited tools and capacity.

Though numerous conflict assessment frameworks and tools for the extractive industry already exist, most are either oriented to companies already operating mines, or complex enough to require external expertise to implement. This Tool is designed to be useful in exploration without external support. Nevertheless, in complex situations of conflict explorers may need to seek expert advice.

The PCE Tool is designed to:

- Provide straightforward steps for community engagement, beginning the first day of exploration
- Aid analysis of complex issues, particularly those that arise in settings of open conflict
- Suggest options for addressing known or potential risks before tensions or conflict escalate
- Provide options for engaging external groups, such as locally-operating Non-Governmental Organizations (NGOs)
- Be applicable in developed and developing countries, and in contexts of conflict or where there exists a legacy of social conflict regarding natural resources exploration and extraction

Making the Business Case for Community Engagement

Extractive companies around the world understand community engagement to be an integral part of their business operations. Particularly for mining exploration, constructive working relationships with local communities can be the difference between a successful, stable project – reducing management and staff time spent on addressing social issues - and one that experiences instability and strife.

> **Tip**
> The process by which a company engages local stakeholders and communities, and the spirit in which this is done, are as important to the success of exploration as drilling itself.

Done well, community engagement establishes mutually beneficial relationships between a company and its local stakeholders, helps to ensure that company operations meet the expectations of local communities, creates an environment conducive to investment, and demonstrates value protection to companies interested in investment or acquisition. Nevertheless, while the presence of private sector investment can be a driver of economic development – through employment, contracts, its supply chain, and payment of taxes – poor relationships with stakeholders can be a driver of conflict that can jeopardize both the investments themselves and local economic and social gains.

Note on Mining and Conflict

When explorers enter into a new community, they become part of that context. Even low-profile exploration crews that go to the field with hammers and tents as their main gear need to be aware that their impacts on local communities are never neutral. Social impacts based on who gets jobs as laborers or security guards, who gets crop compensation, or who lives alongside the dusty road where drilling rigs pass means that some people gain, and others do not. Especially when the context is characterized by an existing conflict, the actions of the company – and in some cases its mere presence – affect the course and nature of the conflict, for better or for worse.

"But…we don't work in conflict areas"

Many exploration teams do not think they work in contexts of conflict. Conflict, however, comes in many forms. There are two types of conflict that exploration companies should be aware of:

Environments with Pre-Existing Conflict: in such situations, conflict is related to the wider socio-political context. It may be unrelated to corporate presence or to the country's mineral wealth. The causes of existing macro and micro-level conflicts can include basic and long-standing issues such as poverty, social and political marginalization, injustice, opportunism, greed, and power struggles.

"Conflict" in these situations may be defined as a) significant social or political instability, including factors that make the future outbreak of violence more likely; b) civil wars, armed insurrections, inter-state wars and other types of organized violence; and c) transitions from violent conflict to peace, in which there is a risk of renewed conflict. It is important to distinguish conflicts that are confined to the local or regional level from macro-level conflicts that can exist between states, between groups of people and the state, or between national-level social groups. Different types of conflicts imply the need for different risk mitigation strategies. There are no quick fixes for these conflicts, and a company neither can, nor should, try to address them on its own.

Company – Community Conflict: here, conflict is related to the relationship between the company and community (both directly affected communities and other local stakeholders). The company's actions either create tensions or conflicts, or enflame existing ones. Even when a company is not directly involved in pre-existing conflicts between local groups, its presence and day-to-day business operations are important to, and have an impact on, their struggles. This type of conflict may reach the company in the form of complaints, demands, threats or obstructive activities. It is often caused by company activities that exacerbate intergroup tension, or cause the company to become a proxy target for grievances unrelated to it. This type of conflict is often present in contexts that have histories of extraction, including small scale mining.

Conflict of either kind can pose serious risks to exploration projects. It is important to use this Tool even if operating in a context that is not conventionally considered one of conflict. Even where conflict may not be about issues that are related to exploration activities, the way in which the exploration company responds to conflict can have profound effects on its relationship with local communities and its ability to maintain stable exploration activities. Particularly in situations of pre-existing conflict, explorers need to develop an awareness of ways to avoid becoming drawn into the conflict or inadvertently fueling it. It is thus necessary to maintain an understanding of the interplay between the presence of exploration and the operating context in order to assess the potential for conflict or tension and to mitigate conflict risks.

OVERVIEW OF THE TOOLKIT

The Tool consists of 5 sequential steps that will lead field staff and management through a set of interrelated guidance questions. These questions form a flexible, recurring process that helps staff analyze and manage the relationship between the context and the explorers' operations.

STEP 1 ANALYZE THE CONTEXT

Analyze and understand the context in which you are operating

Map key stakeholders in context and understand causes and drivers of conflict situations

Steps

- Gather and record information on local context and local stakeholders through analysis and dialogue
- Create stakeholder map and context profile
- Develop indicators for tracking changes in operating environment

STEP 2 ANALYZE THE EXPLORATION PROJECT

Understand aspects of the exploration project that effect local communities

- Clearly define company objectives, resources, and exploration project time frame and phase
- Identify key activities that impact the community both positively and negatively

Steps

- Review company objectives and activities by phase
- Create map of company activities in relation to local context and key stakeholders

STEP 3 IDENTIFY SOURCES OF RISK

Understand how interaction between the context and company activities creates sources of risk and opportunity

- Assess and evaluate the impact of company activities on the context
- Identify sources of risk to be addressed and opportunities to be developed

Steps

- Identify sources of risk in the existing context
- Identify sources of risk based on actual or potential impacts of company actions on the context

STEP 4 ANALYZE RISKS

Assess and prioritize risks and opportunities for company operations

- Assess and evaluate the likelihood and consequence of risk scenarios that pose the greatest harm to exploration and the local community

Steps

- Assess and prioritize risks and determine causes of risk based on the link between company impacts and local context
- Identify areas of priority action

STEP 5 PLAN AND IMPLEMENT MITIGATION OPTIONS

Develop options and approaches for mitigating risks and optimizing constructive engagement opportunities

- Develop potential risk mitigation strategies for preventing company-community conflict

Steps

- Develop and validate risk mitigation plan
- Implement action plans and monitor for indicators of impacts
- Engage company staff and key local stakeholders to corroboratively track effectiveness of risk mitigation strategy

Also in the Toolkit

In addition to the Tool itself, this document contains:

- Tips for how to take a constructive approach to community engagement
- An introductory-level guide to risk management
- A note on collaborating with external organizations
- An introduction to developing indicators to monitor the local context and company-community relationship
- A list of additional resources for stakeholder engagement and conflict-sensitive business practice

Note to Managers

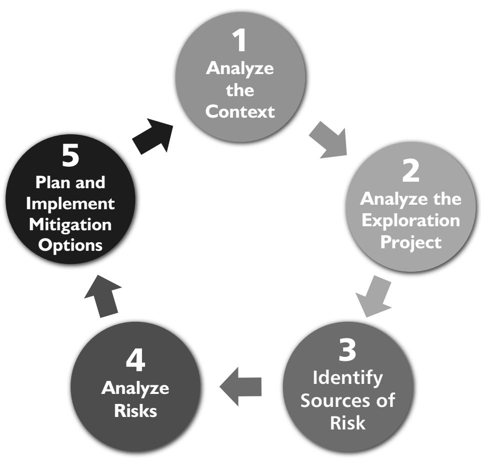
Given the complex nature of conflict, the Tool emphasizes that risk conditions are dynamic and ever-changing. It is intended for use from project initiation through all phases of exploration, and can be utilized in all contexts and by various staff members of exploration teams. It does not replace full impact or risk assessments that may be implemented as the project proves viable, but the analytical process presented here can be used from exploration through construction and into operations.

It is a field Tool, and thus will require some on-the-spot decision making. Field staff will have principal responsibility for engaging local stakeholders and performing the analytical steps. The process of developing and implementing mitigation strategies, however, may at times require both the involvement and responsiveness of various levels of management and the participation of multiple departments, depending on the scale of activities. The effectiveness of the Tool is enhanced when managers clearly signal a commitment to it and allocate time for staff to conduct context and conflict analysis.

The Tool is presented as a cycle. There are two reasons for this.

1. Relationships between exploration companies and communities are dynamic, rather than static. They change continuously, so they need to be assessed frequently. The cyclical nature of the Tool should remind users that the process does not have an end point. After Step 5, start again at Step 1.

2. The last step of the process involves the development of options for changing the way in which the company interacts with the context. When the company changes the practices through which it affects the context, it changes the context itself. The context therefore needs to be analyzed again in light of those changes.



GETTING STARTED WITH THE TOOL

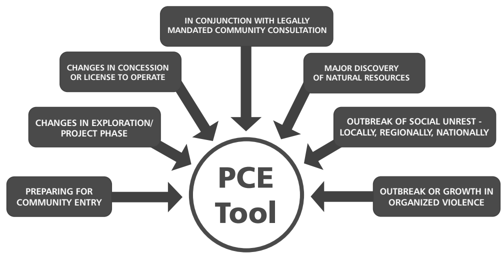
The Toolkit was designed to be as simple as possible, but if you're not familiar with concepts like Community Engagement, Risk Management or Collaborating with Non Governmental Organizations, then read about these key concepts first. Introductory resources can be found within this Toolkit.

Who should use the Tool:

Anyone from the exploration team can take the lead and implement this Tool. This process is useful for all staff, from field geologists and site managers to senior management, as a way to get to know the context of an operation, the people they need to relate with and to, and existing and emergent community issues.

When to use the Tool:

The Tool presents a process of analysis that should be conducted on a regular basis, starting early in exploration. Because every company is different and every exploration site is unique, there is no strict standard for when or how long it takes to implement the process. However, a variety of key events might indicate that the operating context has changed and, as a result, a cycle of the Tool should be implemented.



Build Capacity:

To get better value from the Tool, it can be helpful to prepare your staff. You might want to:

- Develop the skills of one staff person who can facilitate the process within a company that has multiple exploration sites.
- Develop a "Do's and Don'ts" guidance note for community engagement and community entry (See Constructive Approaches for Community Engagement).
- Hold "tool box talks" for geologists.
- Hold routine "risk and opportunities" analysis meetings between project managers, geologists, and security personnel.
- Give direction through reporting requirements - include one or two key questions for field staff to answer on their daily or weekly field reports. For example, whom did they speak with, what was said, what is the mood among community members?

case study

Adapting the Tool in the Andes

Community Relations staff of an exploration company working in the Andes used the Impact Analysis Matrix (presented in Step 3 of the Tool) as a training needs assessment tool. They gauged the level of awareness of conflict issues among the company's staff, including management, junior and senior geology staff, and the Community Relations team itself. The CR team then developed a series of trainings and mini-workshops for their colleagues tailored to their existing level of understanding. Based on the training, the CR team developed a community relations strategy suited to the capabilities of the geologists.

What this Tool does not do

Tip

The Tool does not provide ready-made answers. Rather, it provides questions for which staff and local partners need to work out answers relative to their situations.

The questions are guidance for analyzing the context and local communities, but it is up to staff to think creatively and adapt to the context. If a question does not immediately seem to relate to the operations or the specific context, it should prompt more consideration; apparent lack of relevance may highlight a gap in understanding.

PCE should not be an exercise in ticking off boxes. Neither is it a way to completely avoid risk. Rather, it should be viewed as a process of ongoing engagement to achieve positive outcomes, both for explorers and local communities.

Tips for Getting Started	
Follow the Steps	Pay attention to preliminary context and project analysis; they are fundamental for subsequent risk mitigation strategies.
Start Early	Stakeholder analysis and engagement starts the first day that company staff sets foot on the ground.
Repeat	Use the Tool regularly throughout all phases of exploration and development.
Engage Externally	Engage local stakeholders and community members; you will need their perspectives and opinions for analysis.
Communicate the Process	Secure internal support for the process by communicating the operational value of implementing the Tool.
Get Help	Depending on the severity of conflict in the operating environment, you may need to bring in an external expert to help guide the analysis and strategy development process.

CONSTRUCTIVE APPROACHES FOR COMMUNITY ENGAGEMENT

Community Engagement is the foundation for establishing positive, constructive relationships and for analyzing the context in which you operate. Use it as your principal means to prevent conflict. Engaging and communicating with the local community will be your primary way to understand the setting in which you are working, as well as the relationship between the company and the community. While engagement and communication aids context analysis, it also helps to build long lasting relationships.

Successful engagement is based on some simple, practical principles that represent a blend of ethical considerations and common sense.

- **Respect:** Be respectful in your contact and communication; how you dress, speak, and act will determine the quality of the relationship you have with community members.
- **Honesty:** Ensure full, true and plain disclosure of information and your purpose, so as not to raise expectations.
- **Inclusion:** Be inclusive in the process, so that all parties feel they have an opportunity to share their perspectives. Otherwise, the community will perceive that the company only speaks to those who support the project or are easy to talk to.
- **Transparency:** Establish and maintain complete transparency in all aspects of the process, so that people trust the process that you are undertaking.
- **Communication:** Genuinely and actively listen to community members, rather than trying to sell them on the benefits of the project.

case study

Managing Legacy Issues in Mexico

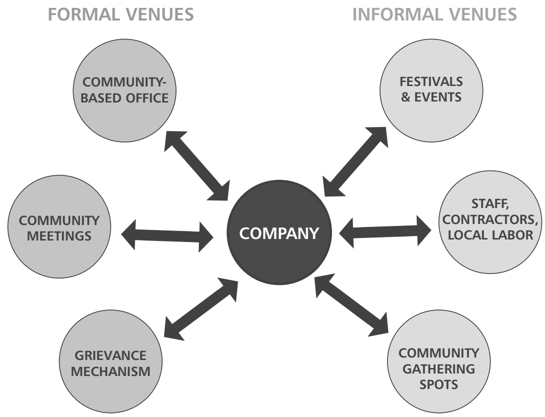
An exploration company purchased a gold concession in Mexico from another exploration company. The new company quickly recognized that the communities in the footprint area had encountered negative experiences with the previous company. The previous company had gone ahead with social investment projects without consulting with the community or gaining their acceptance of the projects. The result was social investment projects that diverged significantly from community expectations. The situation escalated to a level of confrontation and lead to roadblocks by community members. The company took legal action against the community leaders who had organized the protests. This sequence of events created an attitude within the communities of extreme skepticism of promises and commitments.

The new exploration company recognized that the absence of proper engagement and consultation processes was what had created a negative perception within the community. The community relations team recognized the need to approach the communities differently. They decided to maintain a commitment register tracking follow-through on all promises made to the communities. They also concluded that their standing with the community would improve if they were always truthful, even when the community did not like what they had to say. In their dealings with the communities, they made a point of being transparent about what the company could and could not offer.

Understand that communities are not uniform structures. They are heterogeneous, diverse, and change with time, and frequently their members have difficulty expressing their deeper concerns. Everyone is different and you will often have to engage and work with many individuals. Doing so successfully means asking questions of local community members you interact with, as well as listening to and understanding their answers.

Whom to Talk to

- Consult with a range of national, regional, and local representatives (e.g. politicians, NGOs and civil society groups, media, religious leaders, academics, business owners, community leaders). They are valuable sources, helping to provide information and identify additional stakeholders who are relevant to the information gathering process.
- Reach out to locally-operating NGOs who have a deeper understanding of the context and local communities – explain that you genuinely want to understand the local communities and you would like to learn from their perspective and experiences.
- Talk to the community – first approaching community leaders as a way to "gain access" to the community. In the community, reach out to both men and women, youth and elders, and families of varying economic status.



- Talk to the people you hire as laborers during exploration. They can also help you understand the contextual issues and often share what they know about the company with their families and neighbors.
- The people you speak with over drinks in the local canteen can also help you understand community perspectives.
- Use a broad range of venues, both formal and informal, to reach out to local community members.

How to Ask Questions and Listen to Responses

How you ask questions is just as important as *what* questions you ask.

The questions in the Tool are provided as guidance, as opposed to a rigid questionnaire. The process of engagement can be casual (and respectful) rather than feeling like a checklist process. Review questions in both formal and informal settings, including social occasions with staff and local community members. Encourage frank, honest discussions. The meaningfulness and usefulness of the Tool depends on how you engage in discussions, and so the process of discussing the questions can be as important as the answers.

Practice **genuine listening skills** in order to understand local community perspectives. A few simple steps to follow when asking questions and listening to responses:

- **Test your assumptions**. If you have been in the community for any period of time, you have likely started to form your own opinions and assumptions about the local context. Make sure to test these assumptions with questions to other staff and, especially, local stakeholders.
- **Make the implicit explicit**. Ask people about the obvious things happening that no one talks about.
- **Incorporate questions into your daily work functions.** This Tool is meant to be an on-going analysis that should be integrated into your regular work activities.
- Use questions as a guide but **allow the conversation to flow naturally.**
- **Use open-ended questions,** that is, questions that do not invite a "yes" or "no" answer but rather encourage people to speak their minds and elaborate.

  Open question: "What do you think about mining exploration taking place in this community?"

  Closed question: "Do you agree with mining exploration taking place in this community?"

- Ask **different questions around the same subject,** as a way to press for more information and further analysis of potential conflict. Listen carefully to how people speak and the words they use to describe the situation. Also be aware about what people are NOT talking about.
- When speaking to local communities, take care not to bring up words, like "conflict" or "human rights abuses", that have potential negative connotations or insinuate negative situations. **Try to build off of the words and phrases that the people use.**
- Consider both **official and unofficial** perspectives and **formal and informal** relationships.
- As you work through the Tool, you will find that **questions are interrelated**. You may find that the conclusion to one question contradicts that of another, so you will need to revisit previous discussions.
- Demonstrate you are listening by **summarizing** a point or by asking "If I understand you, you are saying that….. Is this correct?"
- When seeking information from local communities, sometimes you will receive more information than you need. **Let people tell you things from their perspective,** as it will help to paint a broader picture of the context and build positive relationships.

If you, staff, or local partners cannot answer a question, it may show a gap in the understanding of the context, relationships, or perceptions regarding the presence of exploration. **Beware of avoiding difficult questions** or difficult discussions, because they are probably the most vital!

In socially complex situations, neutral and objective information is in short supply. **Triangulate information** to help you analyze and understand the meaning of the information you receive.

- **Diversify information sources** as much as possible. When considering apparently contradictory points of view, it is possible to create a more accurate 'on the ground' scenario by triangulating data from different sources.
- Reach out to as **many different stakeholders** as possible for a broad range of perspectives. The more perspectives you consider, the clearer the picture you can build about the local context in which you are working. Gender balance should also be taken into account.
- Consider that not all cultures are open to **talking about conflict issues**, especially tensions within the community, with outsiders. In a politically sensitive area, especially where state intelligence is active, it can be very risky to talk openly about conflict. Certain contexts might necessitate help from a conflict expert or someone practiced in "listening" and community consultation.

When Entering a Community

Your community entry is your only chance to make a good first impression. Think about what you need to know and understand about the community before entering.

- **Develop a Presentation Card.** When entering a new region or community, it is always a good idea to have an official letter from the company to present to stakeholders in the field stating the company's name, names of the employees, and some basic details of the work you will be conducting over the next days.
- **Review appropriate company conduct and key processes.** It is a good idea to review appropriate conduct as a team before any staff has contact with community members. This should include how to present yourself and your work to the community and the company's code of conduct in the field. Once you enter the community you will also receive questions about what the company has to offer to the community. It is best to be prepared. Review with your managers the process and procedures for hiring local workers, local purchasing, and making "payments" for land access.

    Code of conduct in the field should include direction on:
    - Understanding and respecting cultural norms and customs
    - Driving speeds
    - Taking photos

- Fraternizing with local community members
- How to explain exploration activities

- **Determine what you need to know about the community** and region before setting foot into the community for the first visit. You may need to talk with colleagues who have worked in the area or use secondary sources such as development reports.
  - How does the community function and who makes decisions?
  - Are there issues that are going to affect your land access, i.e. land owners versus landless or the size of the community?
  - Are there any safety or security risks in the area to be aware of?
  - Are there any significant social or political issues in the area to be aware of?
  - What potential issues could affect your ability to achieve a community permit for exploration?
  - What are the issues that might arise that will affect your ability to continue drilling, even after you achieve a community permit for exploration?
- **Talk with the respected/traditional leader and the elected/political leaders.** When you arrive in a community, introduce yourself, offer the letter of presentation and explain what you intend to accomplish. In many rural communities, local land owners will not be willing to talk with you until they know you have first presented yourself to the community leader.
- **Be transparent and upfront about what you are going to do.** When approaching local community members for the first time, tell them what you intend to do in language that they will understand. Try not to diminish what you are going to do by simply saying "I am only going to walk around a few hours". If you are going to take samples, say that you are going to take samples.
- **Build an understanding of the local community starting from the first visit.** When you encounter people, ask them simple questions to show interest in the community and to learn how the community "works".
  - How does the community organize itself and make decisions?
  - What is the position of the authorities regarding mining and exploration?
  - Are there members of the community who are not represented in decision-making processes?
  - How do those people get their voice heard and have decisions made?
  - What is the community's way of negotiating social permits?
  - What are the existing income sources for the community?
  - From where does the community get their information?

With these questions you will be ready to start at the first step of the Tool, performing a context and stakeholder analysis.

Good Practice for Community Engagement:

1. STRATEGIC

- Evolves with the business phase and broadens reach throughout the project cycle.
- Uses an analytical process to define key activities, founded on key steps of context analysis, project analysis, risk/opportunities analysis, and mitigation options.
- Responds to and builds on assessment of identified risks and opportunities.
- Addresses both short and long-term objectives of project operations.
- Looks beyond financial resources and considers how to make the best use of company expertise to benefit local communities and the company-community relationship.

2. ALIGNED

- Aligns the strategy of exploration with priorities of local communities, civil society, and government to ensure "shared value"/mutual benefit.
- Integrates community engagement activities into all phases and aspects of company's business activities, including impact management, local hiring and procurement, and community projects.
- Promotes cross-functional coordination and responsibility for practicing constructive engagement among all business units that interact with local communities.
- Engages other development actors in the operating area to learn from their experiences, understand the local context, and align with local operational and development expectations.

3. INCLUSIVE AND PROACTIVE

- Provides for consultation and engagement in the very early stages of exploration, proactively providing information about the exploration project.
- Builds a relationship of trust and builds social "capital" in the project.
- Develops a more predictable and stable working environment through ongoing engagement.
- Brings together parties who may have common needs and reduces competition for resources or benefits through broad and inclusive engagement across social groups and individuals.

4. ACCOUNTABLE

- Demonstrates respect for local communities through willingness to listen to local people and a genuine concern for community well-being.
- Positions the company as a predictable partner that follows through with stated commitments and provides updates regarding commitments that may be delayed.
- Demonstrates sensitivity to existing tensions or conflicts in the local context, utilizing context analysis tools, and engages in a way that reduces the likelihood of competition or tension.
- Reinforces, rather than replaces, indigenous institutions and processes.
- Implements formal and transparent communication procedures that demonstrate accountability, including publication of meeting minutes and a registry for commitments made by the company.

5. MEASURABLE

- Uses indicators to measure the quantity and quality of change in the relationship.
- Tracks changes in community perceptions to gain real-time feedback on company performance.
- Uses participatory methods of monitoring the relationship to build local trust and ensure understanding of local perspectives.

RISK MANAGEMENT 101

Risk management is the identification, assessment, and prioritization of risks, followed by the development of an action plan to minimize, monitor, and control the likelihood and consequence of negative events. The Risk Management process consists of two primary elements:

Risk Assessment

An analysis process to determine the likelihood and consequence of any event that may pose threats to exploration activities and surrounding communities if it were to take place.

Risk Assessment is made up of five steps:

1. Identification
2. Likelihood
3. Consequence
4. Risk rating
5. Prioritization

Risk Mitigation

A process of developing plans that detail how best to proceed with exploration activities in a way that reduces risks.

Risk Mitigation plans are developed by:

1. Determining risk response and treatment
2. Engaging key staff and stakeholders in brainstorming mitigation options
3. Developing appropriate action plans to mitigate risk scenarios

Risk Assessment

For a project, any condition, situation or event that could occur and jeopardize the project objectives or the wellbeing of local communities constitutes a risk. The following steps illustrate a simple analysis that explorers can use to estimate risk and determine the action that should be taken.

1. Risk Identification: Risk identification is a crucial phase; if a risk is not identified, it cannot be evaluated and managed. The purpose of risk identification is to:

- Identify all significant sources of risk or uncertainty associated with the project;
- Articulate risk scenarios based on each source of risk;
- Ascertain the causes of each risk scenario; and
- Assess how risk scenarios are related to each other for analysis as a group.

2. Risk Likelihood: Rate the likelihood that the risk scenario will occur.

Likelihood is the chance that any given event will occur within a given time period. A likelihood of 10%, for example, means that there is a 10% chance of the event occurring within the time period. Another way to frame it would be to say that, in every 10 time periods, the event can be expected to occur once.

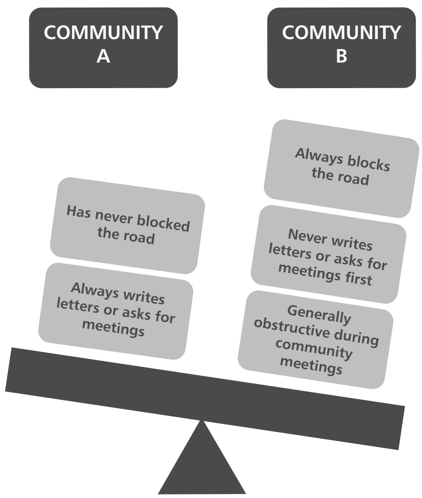
Table 1: Risk Likelihood Table

Likelihood Rating		Definition
A.	Less than 10%	Rare – May occur only under exceptional circumstances
B.	10% - 20%	Unlikely – Will not occur under most circumstances
C.	20% - 55%	Possible – Event may occur under some circumstances.
D.	55% - 90%	Likely – Could happen in most circumstances
E.	90% - 100%	Almost Certain – Expected to happen in most or all circumstances

How likely is it that each of the things that can go wrong will go wrong? Answering this question may involve some degree of subjectivity, but it should be based as much as possible on your knowledge of the context and communities. This is one of the reasons why an analysis of the context is so important.

Assessing Likelihood

> There are two communities in the exploration area. Community B has been quick to set up roadblocks and stop operations each time it has an issue that it wants the company to address. Community A has never blocked the road and typically presents its issues to the company during meetings or by writing letters. The likelihood that the Community B will block the road in the future should be considered significantly higher than the likelihood that Community A will block the road, if the issues that provoke the communities to act are comparable.



3. Risk Consequence: Consequence is a measure of the severity of a risk if it occurs. A broken arm, for instance, is more severe than a stubbed toe. A $1,000,000 operational loss is more severe than a $100,000 loss.

A first step in assessing consequence is to characterize the nature of the risk. Is it a socio-economic, reputational, environmental, security, safety, health, social, or financial risk? Each risk scenario can have more than one potential consequence. For instance, one scenario can have consequences for reputation, the natural environment, health and safety, and finances. In cases where there are multiple consequences of a risk scenario, use the most severe consequence to estimate the risk.

> **Tip**
>
> Communities sometimes remain silent even when upset, especially in settings where they may not feel comfortable to speak up. Understanding the social consequence of a risk may require engaging across a broad range of stakeholders to understand how they truly feel.

Table 2: Risk Consequence Table

Consequence	External Reputation	Natural Environment	Safety & Health	Social / Livelihoods	Financial
1. Insignificant	Minor or no inconvenience to the community. No public attention.	Limited damage to a minimal area of low significance. Easy to repair.	First Aid case.	No response from community. No livelihoods or socio-economic change.	No financial consequence.
2 Minor	Public disturbance in the affected community. No public attention.	Minor effects on environment. Damage is localized and reversible.	Medical treatment case.	Limited verbal or written grievances logged. Minor change in livelihoods or socio-economic status.	Minimal financial consequence.
3 Moderate	Limited local media attention and/or public disturbance in the affected community.	Moderate, short-term environmental effects. Damage is reversible.	Lost time injury.	Multiple written or verbal grievances, marked change in community behavior. Limited change in livelihoods or socio-economic status.	Project viability threatened but recoverable.
4 Major	National headlines, serious community relations impact. Significant levels of NGO attention.	Serious medium term environmental effects. Extensive reversible damage.	Single fatality or permanent disability.	Community-wide outrage. Significant change in livelihoods or socio-economic status.	Project and company viability severely threatened.
5 Catastrophic	International headlines, disastrous community relations. High levels of NGO attention.	Serious, long-term environmental impairment of ecosystem function. Damage is extensive and irreversible.	Multiple fatalities or long-term disabilities where company is found to be responsible and/or negligent.	Community protest and outrage leading to forced shutdown. Massive change in livelihoods or socio-economic status.	Project shutdown.

4. Risk Rating: The next step is to determine the rating as a combination of the likelihood and severity of harm arising from a risk scenario.

Risk = Likelihood * Consequence

Chart the likelihood versus the consequence on a heat map and assign an overall rating to the risk. A risk with a likelihood rating of "B – Unlikely" and a consequence rating of "4 – Major" has a risk rating of "High".

Table 3: Risk Rating Matrix

Likelihood	Consequence				
	1. Insignificant	2. Minor	3. Moderate	4. Major	5. Catastrophic
E. Certain	H	H	E	E	E
D. Likely	M	H	H	E	E
C. Possible	L	M	H	E	E
B. Unlikely	L	L	M	H	E
A. Rare	L	L	M	M	H
L = LOW M = MEDIUM H = HIGH E = EXTREME					

5. Prioritize Risk

Tip

Also prioritize risks that may trigger other risks, or risks that can be mitigated inexpensively and quickly.

Prioritize significant risks based on two considerations:

a. The risk rating – the higher the rating, the higher the priority
b. The involvement of key stakeholders

As the level of risk increases, so too does the priority to respond – more highly rated risks are typically given more attention than lower rated ones.

Tracking Risks

No.	Risk Statement	Likelihood	Consequence	Risk Rating	Affected stakeholders	Actors causing risk	Priority
1	"There is a risk of conflictive action by Coastal people against Highlanders leading to injury and/or death, interruption of the project, and reputational damage to the company."	Likely	Major Injury or death Interruption of the project Reputational damage to the company	Extreme	Coastal people and Highlanders	Coastal people	

Risk Mitigation

Risk mitigation is the process of identifying and implementing measures to reduce the likelihood or consequences associated with a risk scenario.

You should develop action plans to reduce the risks that have been identified as unacceptable (moderate to high). The mitigation plan will depend on the risk being considered, the context in which the risk occurs, the key stakeholders involved, the nature and scale of the proposed exploration activity, and the resources available to explorers.

Develop procedures and practices to reduce risks for the local community and exploration activities, understanding that explorers may not be able to make a significant impact on existing or chronic conflict. Develop action plans with three targets in mind:

I. Responding to the needs of the local population,

II. Ensuring negative exploration impacts are minimized, and

III. Addressing, to the extent possible, some of the conflict or potential conflict issues highlighted during the analysis.

Risk Response

What should you do about the risk?

The risk priority often determines the response that should be used. Based on the risk priority, determine the response by choosing one of the four response options common to most risk management protocols

Accept	Transfer	Mitigate	Cease
Accept the risk as it is	Shift the risk, or part of the risk, to another party, typically buying insurance (this is not possible for many social risks.)	Take action to reduce the likelihood, severity, or both	The risk is too severe to continue the project or activity that incurs the risk

If the risk needs to be mitigated, use the risk rating to determine the approach that is required. The risk rating can also indicate who should be involved in deciding how to address the risks that require response or action.

Table 4: Risk Protocols Table

Risk Rating	Suggested Risk Response Protocols	Who's Decision?
Trivial	No action required and no documents need to be kept	
Low	No additional risk controls required unless: • There is a legal requirement; or • A further reduction in risk is possible at no additional cost. • Monitor to ensure risks remain low and response is appropriate • Document actions taken in daily/weekly report	Make an on-the-spot decision in the field
Moderate	• Establish controls to reduce the risk; costs of controls should be carefully assessed and the most cost-effective solution identified • Where the moderate risk is associated with extremely harmful consequences to people or the environment, take action to prevent harm, even if the cost of controls are high • Risk reduction methods should be implemented within a defined time period • Monitoring is required to ensure risk controls are effective • Document actions taken, in daily/weekly report and issues management system	Discuss with management
High	• Project or activity should not be started until the risk has been reduced • Considerable resources may have to be allocated to reduce the risk; this may affect the viability of the project • Where the decision involves continuation of a project, action may need to be taken to mitigate the impacts and risks associated with previous activity, even if the decision is not to continue with the project • Monitoring is required to ensure risk controls are effective • Document actions take	Discuss with management and consider engaging outside expertise
Extreme	• Project or activity should not be started or continued until the risk has been reduced • If it is not possible to reduce the risk, the project should not be undertaken • Monitoring is required to ensure risk controls are effective • Document actions taken	Engage outside expertise

Action Plan Design

For those risks determined to require a response, an action plan needs to be developed, concentrating on actions and activities that will lessen the risk. Remember, each community is unique, as is each exploration project. The actions taken to reduce the likelihood and consequence of the risk should be based on everything you know about the local context and exploration. The complexity of risk mitigation plans is typically proportional to the complexity of the company's operations. Planning should also include the participation of key stakeholders and community members that are affected by the risk or by the new action plan.

Designing an action plan to reduce a risk typically calls for changing company practices and standard operating procedures. Such changes often impact more than one operational unit. Gaining buy-in for the proposed changes, and assessing their feasibility with those who will be implementing them are both important. For these reasons, it is advisable to involve all relevant operational units in planning mitigation options.

Some companies may have their own in-house software for tracking the risk mitigation plan. For exploration teams, tracking the development, implementation, and monitoring of the plan can be done just as easily with an Excel spreadsheet, and aids in communicating actions to managers. An Action Plan template is provided here to assist in this process.

Table 5: Risk Mitigation Action Plan - Template

Risk ID #	Enter the unique identification number assigned to the risk.
Risk Description	Enter the description of the risk as stated in the risk scenario.
Sources of Risk	Enter the sources of the risk.
Risk Priority	Enter the priority of the risk. You can also include the risk rating here.
Risk Response	Enter the response strategy being used for the risk (Accept, Transfer, Mitigate, Cease).
Risk Status	Indicate the current status of the risk mitigation plan; open, closed, cancelled or on-hold.
Last Updated	Enter the date when the risk mitigation plan was last updated.
Risk Owner	Enter the name of the individual who has primary responsibility for managing the risk.
Consequence if Risk Occurs	Enter a description of the impact/consequence of the risk including scope, costs, and impacted communities.
Areas where Likelihood may be Reduced	Indicate those areas to concentrate on in order to lessen the likelihood of the risk occurring.
Areas where Consequence may be Reduced	List those areas to concentrate on in order to lessen the consequence if the risk does occur.
Action Items (with date)	Within this section list all of the specific actions that will be taken to manage this risk, including how the actions will be performed and, if appropriate, when. Also note specific community members or local stakeholders that should be included in addressing this risk.
Indicators	List the key indicators that will be tracked and analyzed to measure the outcomes of mitigation plans.

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Example Case Implementing the Tool:
Hiring for Camp Construction in Madagascar

Step 1 - At your exploration site in Madagascar, you have noted that people from the highlands have historically enjoyed better education and access to opportunities than have people who live on the coast. Much of the country's wealth, political power, and infrastructural and capital investments are concentrated in the highlands.

Your exploration site is on the coast. Locals at your site routinely express subtle resentment of Highlanders, who are stereotyped as being "arrogant." Most of them say that, during elections, they will vote against any Presidential candidate who originates from the highlands.

Step 2 - To build your base camp, you hire a large number of people. Locals are given preference, but very few have the competencies to fill supervisory and skilled positions. You recognize that nearly all of your better-paying positions are staffed by Highlanders. Coastal people fill unskilled positions.

Step 3 - You realize that your hiring policy may be creating competition and tensions between Coastal people and Highlanders at the project site. You identify two sources of conflict risk: 1) "increasing tensions and division between community groups over competition for resources or benefits" – in this case, the competing groups are Coastal people and Highlanders – and 2) "increasing resentment, frustration or anger among stakeholders towards the company" – in this case, the stakeholders are Coastal people.

Step 4 - You articulate risk scenarios as follows:

1. "There is a risk of violence by Coastal people against Highlanders leading to injury and/or death, interruption of the project, and reputational damage to the company."
2. "There is a risk of conflictive action by Coastal people against the company, leading to theft or vandalism of company property, roadblocks, and sabotage against the company."

Analyze Risks

In analyzing risks, you return to the context analysis conducted in Step 1. You realize that, in the build-up to the most recent elections, there were sporadic incidents of violence between the two groups in communities not far from the project site, and that, at the national level, there are ongoing tensions between politicians belonging to the two groups. You estimate the **likelihood** of Risk Scenario 1 (violence between the groups) as **Likely**. In considering the **likelihood** of Risk Scenario 2 (conflictive action against the company), you realize that you have had relatively positive relations with local people since exploration began. You estimate the **likelihood** of action against the company as **Possible.**

The **consequences** for each risk scenario:

Risk Scenario 1:
- Injury and/or death
- Interruption of the project
- Reputational damage to the company

You estimate the consequences of Risk Scenario 1 as **Major**

Risk Scenario 2:
- Theft or vandalism of company property
- Roadblocks
- Sabotage against the company

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You estimate the consequences of Risk Scenario 2 as **Moderate**

Mapping the risks on a heat map leads to a Risk Rating of Extreme (Likely * Major) for Risk Scenario 1, and a Risk Rating of High (Possible * Moderate) for Risk Scenario 2.

Prioritize Risks

You prioritize Risk Scenario 1, because a Risk Rating of Extreme is greater than a Risk Rating of High.

Step 5 - Though you assigned priority to Risk Scenario 1, during Step 5 you might decide to treat both risks, since both are significant and have the same underlying cause.

An example of action steps that might form part of a plan to mitigate these risks might be:

1. Establish a community Advisory Group that is broadly representative of the community and includes both locals and Highlanders. The purpose of the group might be to define a standard of "fairness" in your hiring practices in relation to both Coastal people and Highlanders and to establish a hiring plan that meets that standard of "fairness".
2. Ensure that the Advisory Group includes individuals that each group recognizes as leaders whom they trust to make decisions on behalf of the group as a whole.
3. Ask the Advisory Group to consider the ways in which job opportunities are distributed to members of both groups, and a system of job rotation among community members so that a broad range of people can take advantage of the opportunity to work for the company and earn income.
4. Communicate the decisions of the Advisory Group widely throughout the surrounding communities through a series of community meetings.

INTRODUCTION TO INDICATORS

An indicator is simply evidence of what is happening in a given situation. What you see happening in local communities, and in local people's interactions with you, may be indicators of the nature of your relationship with the community. If you identify useful and reliable indicators, they can enable you to take stock of the relationship between the exploration company and local communities and to understand the way that the community feels about the company.

Each context is unique; therefore it is necessary to develop indicators that are specific to the context in which you are operating. There are some rules that apply across contexts for effective identification and development of indicators:

- **Define and agree on what success means for exploration and for the community.** Because positive community relations is a shared success, it is imperative to consult with communities to arrive at an agreed definition of objectives.
- **Define and agree on appropriate benchmarks and indicators of success.** Engaging the community allows its members to agree on appropriate benchmarks and indicators for assessing progress (or regression).
- **Use both quantitative and qualitative indicators.** It is often easier to identify quantitative indicators than qualitative ones. In part, this is because companies assess community relations projects in terms of outputs, such as a clinic built or impacts such as improved health status. However, to "measure" the relationship, one also needs to track qualitative indicators such as perspectives of community members.
- **Use both positive and negative indicators.** To capture real change, it is important to look at both increases and decreases in positive and negative indicators.
- **Develop indicators that are measurable and actionable**. Often, more indicators are available than are needed to track impacts. Choose indicators that the company can easily and quickly measure, and that translate into action items within the company management system.
- **If indicators seem to be getting better, it doesn't mean that the situation is necessarily getting better.** It is necessary to check in with local stakeholders and community members to gauge whether the positive indicators are in fact an indication of positive trends. If the indicators are getting worse, it serves as an alarm bell.

Monitoring and Understanding Indicators

Using indicators to **systematically and repeatedly** analyze changes in the exploration area allows you to "measure" the relationship between the company and local communities. Keeping track of indicators helps you to be responsive to changes and ensure those changes are being incorporated into your community engagement strategies and risk mitigation plans. To identify trends in the relationship using this Tool, it is necessary to repeat the process, and to compare the same indicators over and over again.

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While there is no standard list of indicators that are applicable to all contexts, the following are examples of indicators used by exploration teams who field tested the Tool:

In Madagascar: When company staff is invited to local ceremonies and events, it indicates that the community has a favorable view of the company. When staff is not invited to those events, it indicates that the community's view of the company is unfavorable.

In Mexico: When communities send letters inviting the Community Relations team to come and discuss the community's concerns, it is an indicator that the community trusts the company. When communities demand that drilling stop until their concerns are addressed, it indicates that communities do not trust the company.

In West Africa: The local Chief's daily visit to the site of an exploration company's school construction project indicates that the Chief shows support for the project and the presence of the exploration team.

In South America: When the "What Is Mining?" informational posters hung on community bulletin boards are not vandalized or torn down, it indicates that the community has a favorable view of the company.

The following indicators have been found to be relevant across a range of operating contexts. To verify these indicators, or develop your own, involve communities and other partners to build a common understanding of the local community and to discuss appropriate indicators.

Table 6: Indicators: Company-Community Relationship

When a company has a Social License to Operate	When the Social License to Operate is compromised	When a company does not have a Social License to Operate
• People wave back when greeted • New notices from the company remain on the bulletin boards without being torn off • Recognition in the community that the company is bringing together opposing groups and parties that otherwise would not meet • Low, or decreasing, theft levels, destruction of company property • People associate improvements in their quality of life with the company presence • Anti-corporate advocacy groups get no local support • Community requests focus on personal skills development instead of material things. • No or low public outrage following accidents • Communities identify trouble makers and inform company staff about (security) rumors in the community • Communities say they have access to corporate decision makers	• Visible change in community behavior e.g. people stop greeting (waving to) company staff • Community leaders, elders stating they do not feel respected • The same problems arising over and over • Evidence that individuals, rather than the community, benefit from company-community interaction • Staff feels unsafe visiting communities • Accusations of company association with a repressive government • Disproportional negative reaction compared to the nature of an accident • Proliferation of groups that each claim the company should deal with them.	• Rising trends in theft (company is seen as target) • Work stoppages • Increased demands and hostile tone of community • No leniency when accidents happen • Bad press • Increasing crime in the area of operations • Increased conflict between communities or within communities • Kidnappings, targeted assaults toward the company • Sabotage • Increasing reliance on police/ army • Communities say the company is "stealing" resources

Table 7: Indicators – Changing Conflict Conditions Within the Context

Local context is secure and stable	Local context becomes increasingly conflict-affected	Local Context escalates into conflict
• Little or no armed violence • Sense of safety and security among community members • Tensions between community members is dealt with peacefully • Peaceful interactions within diverse communities • Traditional dispute resolution mechanisms, such as elders, peace huts, etc. are functioning • Transitions of power and authority take place peacefully • Historical conflicts have been resolved with successful reconciliation processes • Concerns, grievances, demands addressed and dealt with peacefully • Functioning police services and judicial system • Stable quality of life of community members • Local and national elections take place without violence • Acts of violence occur infrequently	• Acts of aggression using non lethal force (throwing stones) • Violence only involves combatants • Traditional dispute resolution no longer perceived as effective • Power struggles begin to occur between community members • Rise in illicit activity (drug trafficking, smuggling, etc.) • Formation or growth of ideological separatist groups • Increase in demonstrations • Decrease in willingness or capacity of police forces or judicial system • Decrease in socio-economic standing of community • Depletion of natural resources • Media attention on human rights	• Violent acts within communities occur frequently • Use of automatic and lethal weapons • Many members of the population are involved in violence • Insurgent or guerilla groups become armed and more powerful • Rampant illicit activity (drug trafficking, smuggling, etc.) • Wide spread government corruption • Demonstrations erupt into riots and open violence • International attention or sanctions in response to conflict in country • Need for international peace keeping troops • Scarcity of water and other natural resources • Massive displacement due to conflict • Rise in reported human rights abuses

COLLABORATING WITH EXTERNAL ORGANIZATIONS

There may be a range of formal organizations that also operate in the same communities as your exploration project.

- Non-governmental organizations that may be regional, national, or international in scope
- Religious and faith-based organizations, such as churches, mosques, and local chapters of religious orders
- Community-based organizations and associations, such as youth groups or women's groups
- Trade or labor associations

Why engage organizations

Engagement with an organization is a useful way to understand the organization itself, which can be important to context analysis if the organization plays a significant role in the community. It can help the company understand the people the organization represents and the issues that it aims to address. Organizations may also have information about, or perspectives on, the context as a whole that can further a company's own understanding.

Engagement with organizations can also be practically useful for managing company impacts. Some collaborations between the company and an organization, such as joint work on community projects, can help meet both parties' interests. Other organizations may be able to help disseminate information about the company or the project through their networks.

What you need to understand in order to decide how to engage with an organization

- Vision and mission of the organization—what is it about and why it operates where it does.
- Who the organization claims to speak for – some organizations claim to represent large sections of communities, while others may have only small and informal memberships.
- Who the organization represents, and who it does not – some organizations are designed to represent key decision-making stakeholders, whereas others have a broader reach and represent a wide segment of the population.
- Who the organization speaks to – a local office of an international NGO may share information and concerns with its global headquarters and, through advocacy activities, a broad global public. A local youth group, on the other hand, may be relatively unknown and have little to no voice outside of the local community.
- Which members of the community perceive the organization as speaking for them – It is important to substantiate any organization's claims to represent people, and to know who community members trust to represent their perspectives.
- What the organization wants – organizations have widely varying interests, purposes, and activities. All of these will bear upon their relationships to the exploration project.
- What the organization is capable of doing – organizational capacities and resources range widely. An organization's capacities play a large part in determining what role it can play in, and in relation to, collaborating with the exploration project.
- The views of the organization about mining, the company, and the exploration project.

Cautions

Some organizations may be flatly opposed to mining and exploration. While you may not be able to collaborate with them, that doesn't mean that you should avoid engaging them altogether. It may be instructive to hear their perspectives, even if only to know what they will hold you to account for and what you can expect in the way of criticism over the course of the project. Often their opposition to mining and exploration may be rooted in legitimate concerns that are important to take into consideration. In some cases, opposition is also based on misinformation or misunderstanding of the private sector, mining, and sustainable development – engagement in this case can be an important lever for shaping opinions.

Using the Tool as a basis for collaborations

Using the Tool should at the very least push you to find out about organizations that are present in the operating context. Understanding the context (Step 1 of the Tool) means understanding locally-operating organizations, among other things.

Beyond that, all steps of the Tool suggest taking a collaborative approach, such as joint analysis workshops, and will likely benefit from the inclusion of diverse perspectives and bodies of knowledge. In cases where an organization legitimately speaks for important community stakeholders, it can be very valuable, if not essential, to include that organization in processes of analysis and development of risk mitigation options. Engaging an organization also provides an opportunity to learn from it how it engages the community.

RESOURCE PACK – ADDITIONAL GUIDANCE, TOOLS, RESOURCES

The Prospectors and Developers Association of Canada

e3Plus Toolkit - *A Framework for Responsible Exploration designed to help exploration teams improve their CSR practices, and satisfy public expectations of corporate behavior in three areas: Social Responsibility, Environmental Stewardship, and Health and Safety.*

www.pdac.ca/e3Plus

CDA Collaborative Learning Projects – Corporate Engagement Project

"Getting it Right: Making Corporate-Community Relations Work"; Zandvliet, L. and Anderson, M.B. (Greenleaf April 2009)

Practical options addressing constructive stakeholder engagement across all areas of business, including organizational policy analysis, social investment, and key performance indicators.

CDA Collaborative Learning Projects – Do No Harm

"Do No Harm: How AID Can Support Peace – Or War"; Anderson, M.B. (Lynne Rienner 1999)

Tools for analyzing how all areas of operations can impact conflict settings, by exacerbating existing divisions and tensions, or supporting options for community cohesion.

Office of the Extractive Sector Corporate Social Responsibility Counsellor

The role of the Counsellor is to communicate the Government of Canada's expectations regarding corporate conduct, assist companies and stakeholders in the resolution of disputes related to the corporate conduct of Canadian extractive companies (mining, oil and gas) abroad, and assist with the implementation of CSR performance standards. The office is an arm of the Department of Foreign Affairs and International Trade Canada.

www.international.gc.ca/csr-counsellor

Canadian Centre for Excellence in CSR

The Centre for Excellence on Corporate Social Responsibility is one of the 4 pillars of the Canadian government's action plan on CSR - Building the Canadian Advantage.

http://www.cim.org/csr/

International Finance Corporation

- "Performance Standards on Social and Environmental Sustainability"
  http://www.ifc.org/ifcext/sustainability.nsf/Content/EnvSocStandards
- "Stakeholder Engagement: A Good Practice Handbook for Companies: Doing Business in Emerging Markets"

http://www.odi.org.uk/resources/download/1436.pdf

International Council on Mining and Minerals

"Human Rights in the Mining & Metals Sector - Handling and Resolving Local Level Concerns & Grievances"

Toolkit developed by International Council on Mining & Metals (ICMM), UNCTAD, and The World Bank, documenting the policy frameworks, operational practices, and partnership arrangements that deliver sustainable outcomes on the ground.

http://www.icmm.com/library

International Alert

"Conflict-Sensitive Business Practice: Guidance for Extractive Industries"

International Alert's work offers detailed policy and operational guidance, research, advisory and training services to companies operating in conflict-affected areas.

http://www.international-alert.org/pdf/conflict_sensitive_business_practice_section_1.pdf

UN Special Representative of the Secretary-General for Business and Human Rights

"Protect, Respect and Remedy: a UN Framework for Business and Human Rights"

"Business and Human Rights: Further steps toward the operationalization of the protect, respect and remedy framework"

http://www.business-humanrights.org/SpecialRepPortal/Home

Voluntary Principles for Security and Human Rights

A set of voluntary principles to guide companies in maintaining the safety and security of their operations within an operating framework that ensures respect for human rights and fundamental freedoms.

http://www.voluntaryprinciples.org

John F. Kennedy School of Government, Harvard University

"Rights Compatible Grievance Mechanisms – A Guidance Tool for Companies and Their Stakeholders"

http://www.hks.harvard.edu/m-rcbg/CSRI/publications/Workingpaper_41_Rights-Compatible%20 Grievance%2Mechanisms_May2008FNL.pdf

United Nations Global Compact

UN Global Compact's ten principles in the areas of human rights, labour, the environment and anti-corruption. Additional guidance documents on responsible investment in conflict-affected areas.

- The UN Global Compact Ten Principles
- "Guidance on Responsible Business and Investment in Conflict-Affected and High-Risk Areas"

http://www.unglobalcompact.org

PROJECT COLLABORATION

The Preventing Conflict in Exploration Toolkit has been developed in collaboration between The Prospectors and Developers Association of Canada (PDAC), World Vision Canada, and The Corporate Engagement Program of CDA Collaborative Learning Projects, Inc., and supported by the Government of Canada - Department of Foreign Affairs and International Trade. The partners identified "understanding and dealing with conflict, conflict prevention, and community engagement" as issues where NGOs and industry have mutual needs and interests, and around which they can find common ground for collaboration. The Toolkit adapts and integrates components from each organization's established tools, including PDAC's e3Plus – A Framework for Responsible Exploration, World Vision's Making Sense of Turbulent Contexts, and the Do No Harm Framework and the Corporate Engagement Program's Framework for Analysis of Corporate-Community Relations of CDA Collaborative Learning Projects.

Development of the Toolkit is also based on experiences and feedback collected during field testing at four exploration sites. The partners express their gratitude to IAMGold Corporation, Ambatovy, Golden Valley Mines Ltd., and Torex Gold Resources for providing the time and resources to enable visits to their exploration sites, and to their staff for their dedication to testing the Toolkit and providing invaluable feedback. The partners also recognize the substantive input and feedback provided by numerous NGO representatives from field test countries and Canada, a range of company representatives, government authorities in field test countries, and consultants and responsible-business practitioners, for help in finalizing the Toolkit.

CDA COLLABORATIVE LEARNING PROJECTS

The Corporate Engagement Program (CEP) is part of CDA Collaborative Learning Projects, a non-profit organization that is committed to improving the effectiveness of international actors who provide humanitarian assistance, engage in peace practice, and are involved in supporting sustainable development. Through field assessments, trainings and consultations, CEP collaborates with companies to help them ensure they have positive rather than negative impacts on the communities where they operate. As part of this approach, CEP assists companies in the development and implementation of practical options to build positive, constructive relationships with local communities. Since 2000, over 60 international companies - mostly from the extractive industries - operating in Africa, Asia, Australia and North and South America have participated in the Program. CEP has reported on more than 30 site visits in more than 20 countries, including areas of social and political tension such as Nigeria, Colombia, Sudan and Myanmar/Burma. Findings from CEP have been captured in the book Getting it Right: Making Corporate-Community Relations Work (Greenleaf April 2009).

PDAC

The Prospectors and Developers Association of Canada (PDAC) represents the interests of the Canadian mineral exploration and development industry. Established in 1932, the PDAC now has more than 7,500 individual members (including prospectors, developers, geoscientists, consultants, mining executives, and students, as well as those involved in the drilling, financial, investment, legal and other support fields) and 1,000 corporate members (including senior, mid-size and junior exploration and mining companies and organizations providing services to the mineral industry). The PDAC's mission statement is: "To protect and promote the interests of the Canadian mineral exploration sector and to ensure a robust mining industry in Canada. The PDAC will encourage the highest standards of technical, environmental, safety and social practices in Canada and internationally". The association's activities and the services it provides fall generally into three categories: advocacy, information, and networking. The association is best known for its annual convention, trade show, and investors exchange. In 2011, this event attracted over 27,000 attendees from more than 120 countries.

World Vision

World Vision Canada (WVC) is one of the few international NGOs that engages with the extractive industry and that industry's growing interest in responsible community engagement. WVC has been engaging with the extractive industry over the past 10 years through implementing local projects for sustainable development. WVC has the core competencies and is well placed to lead an innovative initiative to incorporate conflict-sensitive good practice with CSR practices and good governance. WVC has developed a relationship with the Prospectors and Developers Association of Canada (PDAC) and has been involved in the launch of "e3 Plus". WVC has an international and long-term field presence, which makes it a suitable partner with stakeholders such as industry and government for sustained relationships with the community. WVC is a member of the steering committee of the Devonshire Initiative which brings together NGOs and the extractive Industry to foster mutual understanding and enhance communication among both sectors.

Key Findings from An Evolving Framework for Outward Investment

Chinese state-owned enterprises often have easy access to investing in certain countries in Asia, Africa and Latin America because of China's political and diplomatic influence and the low investment thresholds in some recipient countries. The relationship with governments and business partners is given much more attention by Chinese enterprises than the relationship with communities or CSOs/NGOs. This results in a gap, where communities and local civil society organizations feel their concerns are often not considered…

This results in mounting discontent among affected people and increasing tension between Chinese enterprises and local communities. In order to control and mitigate such risks, China needs a more balanced investment model with closer links to the communities.

Effective consultation needs sincere attitudes. Some Chinese enterprises see communications with communities as a way to advertise, but this self-centered communication style does not help enterprises to learn new information, and may even be met with more suspicion. In addition, when enterprises talk only about the benefits they may offer to communities, this may generate unrealistically high expectations within communities, which can lead to profound disappointment and resentment when the expectations are not realized. Every word and action in communications with the community can reflect whether the enterprise has a sincere attitude and fully respects communities' opinions.

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