

# China Law & Practice

## China's auto industry explained

**China's auto industry has faced many changes in market entry policy, enforcement action and sales and distribution rules, but 2015 could be one of the most difficult years so far. Here is what car makers need to know to survive**

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Over the past three decades, the China automotive industry has risen to become the largest in the world based on unit sales. Off the back of this growth, foreign automakers have, in an otherwise stagnant industry, enjoyed substantial, and in many cases, spectacular, success in China.

The industry's rise has been carefully managed and nurtured by the Chinese government with the ultimate objective of developing a domestically driven automotive industry. Their basic policy strategy has been to open market access to foreign automakers in exchange for technology transfer through a 50:50 Sino-foreign equity joint venture structure. However, recent regulatory changes and enforcement action within the sector suggest that the government is not satisfied with the ways things are working, and the fallout has unsurprisingly affected the foreign players.

### Adjustments to market entry policy

Since China's entry into the WTO and the availability of the joint venture structure to foreign automakers, the market has become proliferated with a maze of complex partnership structures between domestic and international players supported by a fragmented components and parts sector. The transfer of manufacturing capability and know-how, however, has been limited and certainly hasn't reached the level that the government had hoped. Foreign automakers continue to carefully guard their best technology from the China side and there has been very little in terms of actual product development within China. The failure of the joint venture structure to achieve the requisite levels of technology transfer can in part be attributed to the continuing inadequacies of intellectual



property (IP) protection in China but also to the cross-holding partnerships where a local partner can hold more than one joint venture interest, which increases the potential IP leakage and scope for unhealthy competition.

As a result, the benefits of continuing to retain the 50:50 joint venture cap have been debated in recent years, including by government policy makers. At the risk of sounding cynical, it is clearly in the interests of some to maintain the status quo of a handful of predominately state-owned enterprises continuing to enjoy a 50% stake in profitable joint venture arrangements driven largely by the foreign joint venture partner and fuelled by the domestic consumers' appetite for foreign brand vehicles.

The latest edition of the *Foreign Investment Industrial Guidance Catalogue*, which will replace the 2011 edition, provided the government with the opportunity to address the foreign ownership issue within the automotive sector. A draft of the Catalogue (2014 Draft Catalogue) issued by the National Development and Reform Commission (NDRC) on November 4 2014, provides some insight into how the government proposes to steer the industry.

Whilst the 2014 Draft Catalogue proposes to reduce the number of restricted industrial sectors for foreign investors by more than half, significantly cut the number of industrial sectors that are currently limited to joint ventures and partnerships as well as decrease the number of industrial sectors that require a Chinese majority shareholder, the 2014 Draft Catalogue moves in the other direction in a number of key areas of the auto sector.

Firstly, it is clear that the 50% cap on foreign ownership is to be maintained. Further, the 2014 Draft Catalogue mandates that the same foreign investor is not permitted to invest in more than two joint ventures which manufacture the same category of auto vehicles (i.e. passenger cars, commercial cars and motorcycles) in China, although this restriction will not apply if the foreign investor acquires or merges other automobile manufacturers in China together with a Chinese joint venture partner. The restriction on the number of joint ventures has been put in place under the 2004 edition of the *Automotive Industry Development Policy* (汽车产业发展政策) issued by the NDRC, but it is the first time that this restriction has been integrated into the *Foreign Investment Industrial Guidance Catalogue*.

Although categorised as "encouraged" under the 2007 Catalogue, the manufacturing of complete auto vehicles was later changed to "permitted" under the 2011 Catalogue subject to regulation by the *Automotive Industry Development Policy*. The 2014 Draft Catalogue, for the first time, explicitly categorises manufacturing of complete auto vehicles as a "restricted" industry, essentially meaning that new foreign investment projects in this area will be subject to more rigorous scrutiny by the NDRC in future, with the power of examination and approval reserved for higher levels within the NDRC.

On the other hand and consistent with the desire to continue to facilitate product development in China, in the area of manufacturing and research and development (R&D) of certain auto electronic devices (including bus network technologies, electronic controllers for electric power

steering systems and embedded electronic integrated systems), the 2014 Draft Catalogue abolishes the requirement of foreign investors to work with Chinese partners in the form of joint ventures. Once it takes effect, foreign investors will be permitted to **establish wholly foreign-owned enterprises** (WFOEs) in these sectors.

The maintenance of the 50% foreign share percentage cap and the restriction on manufacturing of complete auto vehicles are clear indications of the Chinese government's desire to gradually tighten up foreign investment in the auto manufacturing industry with a view to foster the development of domestic auto brands. However, is the continuation of the 50:50 joint venture requirement, in fact, hindering the ability of Chinese companies and brands to develop?

There is clear logic in encouraging foreign participation in the areas of auto parts and R&D where expertise and product development is key; yet the continuing ability of a handful of Chinese companies to continue leaning on foreign joint venture partners provides little incentive for foreign automakers to explore more commercially viable arrangements and, in fact, hinders the ability of the smaller domestic automakers to compete both domestically and in the export market.

## **Aggressive enforcement action**

2014 also saw the government flex its other policy-guiding muscles in the automotive sector through enforcement. The NDRC began a series of enforcement actions against a variety of perceived monopolistic practices under the **PRC Anti-Monopoly Law** (AML) against foreign auto brands in China.

### ***Horizontal monopoly agreements***

On August 20 2014, the NDRC levied record fines of Rmb1.24 billion (around US\$200 million) against 10 Japanese auto parts makers for alleged collusion to fix prices of certain components sold to the Chinese joint ventures operated by Toyota, Honda, Ford and other multinational auto companies. In its announcement, the NDRC claimed that the auto parts suppliers had negotiated prices and agreed on quotes for orders between 2000 and 2011. Such horizontal monopoly agreements are explicitly prohibited under Article 13 of the AML.

### ***Vertical price maintenance agreements***

In September 2014, local branches of NDRC in Hubei Province and Shanghai also carried out investigations into the vertical monopolistic practices of Audi, Volkswagen and Chrysler regarding controlling prices for spare parts and repair/maintenance in downstream markets through certain provisions of distribution agreements, and imposed substantial penalties. The vertical restraints imposed by the foreign brands upon their dealers constituted "vertical monopoly agreements" that are prohibited under Article 14 of the AML.

## ***Abuse of dominant market position***

Although there haven't been any reports on investigations or penalties imposed by the NDRC on the basis of "abuse of dominant market position", some foreign brands may have been violating the AML in this regard. It is widely reported that some foreign brands have been forcing their dealers to purchase slow-selling types of vehicles together with best-selling types from the manufacturers. Such forced sales constitute "tie-in sales" which would be regarded as a prohibited abuse of dominant market position under Article 17 of the AML if carried out by brands holding dominant positions. Given the market share being enjoyed by some leading foreign auto makers in China, they stand to be deemed to hold dominant positions in specific market segments. As a result, it is highly possible that the NDRC will target such tie-in sales carried out by foreign automakers in the near future.

Many see the enforcement action as representative of the government's random attempts to enforce its protectionist policy. There may be some truth in this, but the Chinese government is clearly looking to attack what it perceives as unfair pricing practices brought about by the dominant position enjoyed by foreign automakers. By directing its enforcement action through antitrust laws, the government is showing its desire to break down the entrenched commercial relationships and practices that have largely been cemented through the structural requirements imposed by market entry regulation.

## **Amendments to distribution rules**

To further address the pricing practices of foreign automakers, especially the pricing of imported automobiles, the Chinese government has also introduced new distribution channels and reduced foreign automakers' control over their authorised distribution channels. On October 23 2014, the General Office of the State Council issued the *Several Opinions on Strengthening Import* (国务院办公厅关于加强进口的若干意见) which provides in Article 5 that the Chinese government will "modify relevant provisions on auto brand sales and carry out pilot application of parallel auto imports within the China (Shanghai) Free Trade Zone" (Shanghai FTZ). Correspondingly, the Shanghai Municipal Commission of Commerce, Management Committee of the Shanghai FTZ and several other local authorities have jointly issued the *Circular on Launching a Pilot Project for the Parallel Import of Motor Vehicles in the China (Shanghai) Pilot Free Trade Zone* (关于在中国（上海）自由贸易试验区开展平行进口汽车试点的通知) (Parallel Imports Circular) on January 7 2015. This is a clear signal that the Chinese government is amending its auto distribution rules in a more consumer-friendly direction.

"Parallel imports" of automobiles refer to the practice of car dealers importing genuine automobiles from foreign markets to China without the permission of the foreign automakers or their authorised dealers, usually at a substantially lower price. This forms an alternative channel for customers to purchase imported vehicles, in addition to the traditional authorised dealers. Although China has never explicitly prohibited parallel auto imports, the *Administration of Branded Automobile Sales Implementing Procedures* (汽车品牌销售管理实施办法) jointly

issued by the Ministry of Commerce (MOFCOM), NDRC and State Administration for Industry and Commerce (SAIC) in 2005 provide that foreign auto makers must authorise chief dealers to establish distribution networks and sell cars in China, while the chief dealers and lower-level authorised dealers must be record-filed with the SAIC. These rules have helped foreign automakers keep a tight grip on the distribution network, and parallel auto imports have long lived in a grey area. As a result, the number of automobiles that have entered China through the parallel import channel is minimal.

Things were looking up last year on August 1 2014 when the SAIC announced that auto dealers will no longer be required to record-file with the SAIC from October 2014, thereby improving the legal status of parallel importers. With the issuance of the Parallel Imports Circular, the deregulation of parallel auto imports in the Shanghai FTZ means that parallel auto imports have finally established legal standing in China, even though at this stage the business of parallel imports is only available to enterprises satisfying very strict criteria, such as enjoying three consecutive years of profits and not less than Rmb400 million annual car sales volume. It is also reported that the *Administration of Branded Automobile Sales Implementing Procedures* are being revised to further loosen regulations upon auto vehicle distribution channels.

The major obstacle for the development of parallel auto imports is that the importers are not entitled to after-sales services from foreign brands' authorised dealers. To address this issue, the Parallel Imports Circular not only proposes to introduce a "third-party public service platform" which will offer auto vehicle maintenance, services and auto parts provision to consumers of parallel imports, but also requires the parallel importers to guarantee the quality of imported vehicles and undertake responsibilities such as recall, after-sales services and the "three guarantees" of repair, replacement or refund for defective vehicles. Considering that the Chinese government has been establishing new free trade zones using experience gained from the Shanghai FTZ, the pilot application of parallel imports in the Shanghai zone may have a substantial impact on the price of imported automobiles in the long term.

## **Adapting to the changes**

China is still one of the most lucrative markets for foreign automakers, but they need to adjust their strategies in order to thrive and survive as the government looks to continually steer the industry through both regulation and enforcement.

It is worth noting that the "manufacture of key parts and components of new energy automobiles" is listed in the encouraged category under the 2014 Draft Catalogue. Also seen in this category is the R&D of key technologies such as variable geometry turbocharging (VGT), variable nozzle turbocharging (VNT) and the R&D of automobile electronic devices. Foreign automakers may need to take a more proactive approach to expand their shares in these emerging industrial sectors in China. More ominous, however, is the re-categorisation of complete vehicle manufacturing from permitted to restricted and whether new ventures are under greater scrutiny. This signals a more coercive approach by the government to future projects; for instance in the electric vehicle sector, which is clearly seen as a key area of development in China.

The NDRC's attack on monopolistic practices is clearly an attempt to address the lack of competition in the market and is expected to continue. Foreign automakers must take much more rigorous compliance measures in the areas of antitrust law. This is going to require closer supervision over dealers regarding collusion, as well as paying attention to the wording of price recommendations to dealers and affiliated auto parts sellers in distribution and after-sale service agreements. Furthermore, foreign automakers enjoying dominant market positions in certain market segments need to be more cautious in the price setting of their products, especially auto parts. A reasonable reduction of price may put foreign automakers in a more favourable position in their negotiation with the government over anti-monopoly investigations.

Finally, facing the incoming competition of parallel auto imports, foreign automakers should respond by further enhancing the after-sales customer services provided by their authorised dealers. The major weak point of parallel importation is the lack of after-sales service. Although the Parallel Imports Circular has proposed the public service platform and a quality guarantee by the parallel importers, it is not clear whether this can satisfy the demand of consumers given the level of sophistication of modern auto vehicles. As a result, high-quality after-sales services will ensure the advantage of authorised dealers in competition with parallel imports. In addition, if the amount of parallel auto imports increases substantially in the future, foreign auto makers should also consider taking proactive responses by allowing automobiles of parallel imports to enjoy after-sales services provided by authorised dealers, so as to take their own shares of the parallel import market.

However, the market entry changes fall short in one important regard: facilitating the development of a domestic automotive market. Given the stage of its evolution, only when all parties, both domestic and international, can compete on a level playing field driven by competition and economics rather than the government's regulatory hand, will the Chinese automotive market move beyond its current position. The failure to further open up the Chinese automotive market by abolishing the 50:50 joint venture rule in the latest edition of the Catalogue is an opportunity missed for both international and domestic players.

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