

Chinese water

Chinese water torture

Thanks to continuing regulatory reforms, foreign investors are now allowed to participate in both the production and distribution side of the industry. However, as in other areas of the Chinese economy, one of the main concerns for investors remains the role and level of involvement of government authorities.

A new model for investment in infrastructure projects, which was recently introduced in the People's Republic of China (PRC), and the involvement of government authorities in the utilities sector today are being analysed in a greater number of projects. This is in light of a concession-based legal framework as opposed to the previous prevailing framework, which was rather based on foreign direct investment laws and regulations. The merits and shortcomings of this new concession-based model on Chinese water projects are discussed below.

China's water crisis

China is currently listed by the United Nations as one of the 13 countries in the world facing the worst water shortages. The latest figures from water resources authorities show that China's average annual water resources of 2,200cu m per capita are only a quarter of the world average and of 660 large Chinese cities, more than 400 are chronically short of water. Water shortages result in an estimated nationwide loss of Rmb230bn worth of annual industrial output.

In the context of massive domestic and industrial water consumption, aggravated by rapid economic growth, urbanisation, and better living standards, the Chinese vice-minister for water resources recently stated: "With China's rapid industrialisation and urbanisation,

With its rising urban population and rapid economic growth, China today is one of the world's most active markets for investment in water and wastewater projects, write **Nadine Ganesan** in Beijing and **Stéphane Gasne** in Shanghai, **Gide Loyette Nouel**.

the shortage of water resources has become one of the major factors restricting the country's economic development and progress of society."

In tackling this water crisis, the Chinese government has set itself unprecedented investment targets for the urban water sector² and issued regulations increasingly favourable to foreign-funded projects. In 2002, the Foreign Investment Guidance Catalogue listed water treatment for bulk supply and wastewater treatment projects among the category of "encouraged" projects, while foreign investment in the construction and management of urban water supply and drainage networks in big and medium-sized cities were classified among "authorised" projects.

This categorisation means foreign participation in water and wastewater treatment projects can benefit from incentives in import duties and value-added tax on imported machinery and, despite still being limited to minority participations, experienced foreign water sector operators can nonetheless apply their know-how to engage in the distribution and customer service side of the water business.

The current outlook for private investors in the water sector is extremely promising. The outdated state of most Chinese water plants and distribution networks urgently requires new investment and both national and local governments lack the financial resources, technology and management experience to themselves invest in the new facilities required to meet existing policy targets. Furthermore, investment in the water sector is largely a matter of local government control and is comparatively free of the bureaucratic wrangling that is a feature of other sectors such as electric power.

Nonetheless, any investment in public utilities invariably subjects commercial and project-financing considerations to be more heavily influenced by government intervention and public interest considerations. Given

The China style model is generally implemented in localities

that China's regulatory framework for investment in the water sector is still evolving, the fluctuating degree of government control in shaping the terms of investment remains the main concern for private investors. Recent regulatory developments indicate that aside from certain incentives, the national government is not yet willing to give a free reign to foreign investors. The main concern for private investors remains the framework for investment.

Two competing models

The application of BOT structures and concession-based models to finance urban water plants and attract foreign investment was first introduced in 1995, when various Chinese ministries led by the State Planning Commission launched a pilot BOT programme mainly through the issuance of two circulars known as the BOT Circular³ and Concession Circular⁴ (the circulars).

The main purpose of the programme was to allow cautious experiments in foreign invested BOT projects in a limited scope of industrial sectors, including urban water supply plants. This was to be followed by a more comprehensive legal framework for concessions of infrastructure projects to be enacted by the State Council based on the experience gained from the pilot programme.

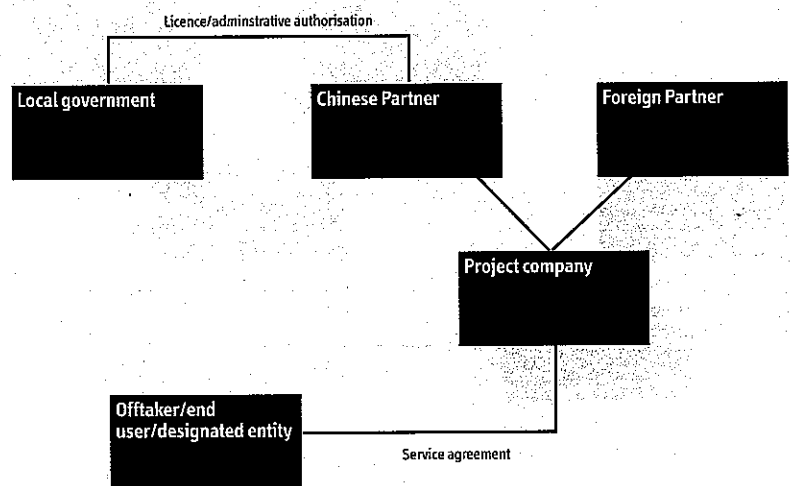
Not only did this not materialise, but, given the limited scope of application, experimental purpose and complex approval procedures set forth by the circulars, only three projects were actually launched under the pilot programme, two of which reached financial close: the Laibin B power plant project and the Chengdu No 6 water plant project. Chinese authorities decided to put an end to the pilot programme due to a changing environment in the 2000s and the circulars were abolished in 2002.

Infrastructure projects in China have been, and continue to be, developed according to two principal models: a China-styled model and a concession-based model.

The China-styled model (see table 1), which is at variance with standard BOT structures used internationally, can be viewed as a form of traditional corporate finance model that is supported by the legislation applicable to foreign investment enterprises. In a typical China-styled BOT, a project company usually taking the form of a joint venture is established between a foreign investor and a Chinese enterprise (usually a state-owned enterprise owned by the local government), for the construction and operation of an infrastructure project.

While the foreign investor usually contributes cash and technology to the project company, the Chinese enterprise makes its contributions in kind by providing, for example, land use rights and certain assets. The project company then enters into a service agreement with either the Chinese enterprise or a dedicated off-taker, the contents of which is quite similar to that of a concession agreement.

TABLE 1 - CHINA STYLE PROCUREMENT MODEL



The China-styled model is generally implemented in localities where no concession legal framework has been put in place. Under this model, the role of the local government is limited to approving the joint venture contract setting out terms of the parties' co-operation with regards to the underlying project.

Under the concession-based model (see table 2), the role of the local government is significantly enhanced as it is itself a party to a concession agreement concluded with the project company. This model is implemented in localities where a concession legal framework has been put in place.

The main characteristic of this model, the existence of a concession agreement, is regarded as being quite favourable to investors as it allows the parties to address important issues and ensure adherence to certain key principles, which are often otherwise not addressed or inadequately dealt with in the absence of a comprehensive underlying legal framework on concessions. Such issues and principles include equitable allocation of risks, structure and control of tariffs and support from the public sector.

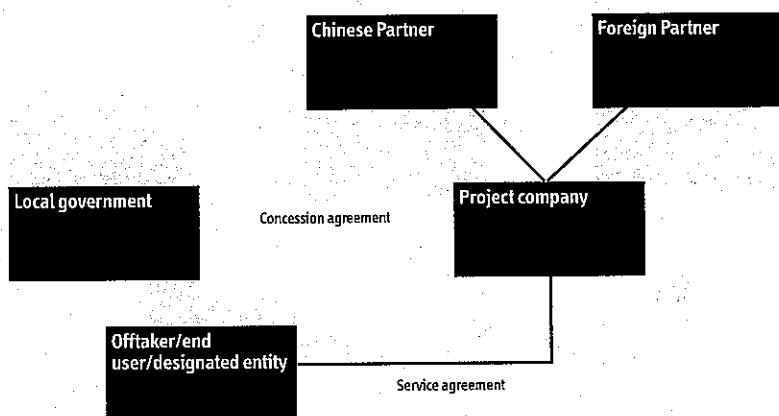
In a concession agreement, the respective rights and obligations of the government authority and concessionaire, specific concession rights, and the status of existing local incentives, guarantees and subsidies from local Chinese governments can be better ascertained, allowing for a real and equitable public-private partnership.

Co-operative joint ventures (CJVs) have, under both models, generally been preferred for the establishment of the project company because of the flexibility they provide to its partners in terms of investment, dividend rights

The national government is not yet willing to give free reign to foreign investors.

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TABLE 2 - CONCESSION BASED MODEL



For the first time, the concession measures offer a specific legal framework.

and corporate organisation. Of notable particularity is the possibility for foreign investors to recover investment in priority through preferred dividend mechanisms to the extent that assets of the project company are transferred to the Chinese party at the end of the term of the project company.

Since the early days of foreign investment in infrastructure projects in China and in the absence of specific BOT legislation and of a unified concession-based legislation, the China-styled model has been the preferred structure for three-quarters of currently active water and wastewater projects in the PRC.

However, in the remaining cases, a number of local governments, conscious of the need to facilitate investment in concession-based water utility projects, have, despite the lack of a comprehensive regulatory framework for concessions at the national level, taken the initiative of setting up their own local concession regulations for the sole purpose of implementing specific projects under the concession-based model, which have taken the form of BOT and TOT concession projects.

This flexibility in shaping investment structures for foreign investment in the water industry may, however, be substantially curtailed by the effect of recent legislation issued by the central government. These include the eagerly awaited utility concession regulation issued in March 2004 by the Ministry of Construction (MOC), namely the Administrative Measures on the Concession of Municipal Public Utilities⁵ (the concession measures).

As ministerial level administrative regulations, the concession measures have the same authority as local government regulations and are less authoritative than national laws or State Council regulations. However,

together with the Administrative Licensing Law and the Bidding Law, they are expected to wield a heavy influence on the practice of local governments and standardise the granting and form of concessions in China.

The concession measures

For the first time, the concession measures offer a specific legal framework applying to concessions of urban utility industries, including the supply of water, gas and heat, public transportation, wastewater treatment, and garbage disposal.

Under these measures, the selection of concession projects is decided by governments at the provincial level through legally defined procedures, while the actual attribution of concessions is approved by the directly governed municipality, city or county (except where national-level approval may be required for large projects).

This is consistent with existing local concession rules. The MOC assumes the supervisory role for urban utility concessions at the national level, while provincial construction commissions and bureaux assume the same role in their own provinces. However, the concession measures acknowledge that urban utility industry authorities at the municipal or city level are the departments in charge of actually implementing the concessions (the authorities).

The concession measures require that concessions be granted through public tender processes with competitive bidding. Previous local utility concession rules and the MOC's own circular had no such universal public tender requirements.

Finally, the procedures address a broad range of concession issues largely in general terms, such as the terms of the concession agreement, the responsibilities of the concessionaire and of the government as conceding authority, the government's regulatory and intervention powers.

In analysing the relevance of the provisions of the concession measures for foreign investors, a number of areas are perceivably well below expectations. Indeed, the evolving concession agreement legal framework applicable to water utilities that is presented in the concession measures lacks details for many legal considerations that private investors consider fundamental for the purposes of project financing.

Authorised approval authorities

Although both the central and local governments are in consensus for attracting private funds to invest in the public utilities sector through the concession measures, the central government also perceives over-investment as a threat to economic stability. In this respect, it has issued the Administrative Licensing Law, which serves to regulate market access through and hence the granting of

There is no provision prescribing the form of the tariff structure

permits in special industries directly affecting the public interest, including the granting of concession rights.

Under the administrative licensing law, concession rights can only be granted by government authorities properly authorised to do so by legislative bodies, namely the National and Provincial People's Congresses and the central and provincial governments. Hence, government authorities that are not expressly authorised by legislative bodies are not able to grant concession rights under the concession measures.

Moreover, the administrative licensing law requires that any previous regulations on administrative licensing, such as former local regulations on concession, be reviewed by the formulating authorities in accordance with its provisions. If such regulations are not in compliance with the administrative licensing law, they will be deemed ineffective from the effective date of the administrative licensing law.

Competitive bidding procedure

In the selection of a concessionaire, the concession measures provide that concessions should be granted through a public tender process based on the principles of openness, equality, fairness and the priority of public interest.

Local governments could theoretically challenge the concession measures by arguing that, in omitting to address direct or negotiated concession grants, they do not expressly prohibit them. This issue is yet to be tested and in any event, the state council will, under the PRC Legislation Law, adjudicate in conflicts between a ministerial regulation and a local government regulation.

Although competitive bidding complies with international practice for concession-based BOTs, this feature could be seen as an important practical drawback for foreign investors. Currently, Chinese developers are already involved in one-third of water and wastewater projects, are becoming more competitive and are known to take a very aggressive approach in their financial, technical and legal proposals, giving them a clear competitive edge over foreign investors.

Vague contractual requirements

The concession measures require that the contents of concession contracts include terms regarding service standards, maintenance of the facilities, safety management, performance guarantees, termination, liability for breach, dispute resolution and adjustment mechanisms. However, no other specific requirements are set forth except for the duration of a concession agreement, which should not exceed 30 years (more than the usual duration of a water project).

There is no provision prescribing the form of the tariff structure, nor is there any reference to the necessity of incorporating take-or-pay mechanisms, which still constitute key conditions for the financing of any BOT project

in the water sector, as long as the scope of the concession does not extend to the operation of public networks.

A provision of notable interest relates to the appropriate compensation to which the concessionaire is entitled when it suffers a loss as a result of any government decision made in the public interest or any default of the conceding authority. However, it remains unclear to what extent such principle allows for compensation of the concessionaire upon the occurrence of a change in law, political force majeure event or other termination event not caused by the concessionaire.

China-style BOT - Still attractive

The concession measures reflect the Chinese government's conflicting policy goals of attracting investment in the water sector against the wider aim of controlling the level and nature of investments in the Chinese economy. In attempting to fill the legal gap for investment in the water sector, however, it seems that the government has swayed too far in favour of the latter policy objective and may have unwittingly placed onerous burdens on investors (such as the insistence on onerous public tendering requirements) while omitting to address the complex practical legal issues raised by the unique Chinese legal environment.

Specifically addressing such issues would have been very useful in providing greater certainty for present and potential developers, financiers and government authorities in seeking a way to facilitate their involvement in concession-based utilities projects.

In this respect, it is important to note that China-styled BOTs may continue to be used in Chinese cities, whether or not the relevant government authorities have been empowered to grant concession rights.

China-styled projects are still attractive as they benefit from a greater legal certainty than concession projects: all of the project agreements are entered into between equal parties and are therefore subject to the application of the Contract Law⁶. In comparison, in a concession project, it is still unclear what law would apply in case of disputes arising between the parties, as no law governing administrative contracts has been promulgated yet.

The actual impact of the concession measures will also eventually depend on the willingness of provincial authorities. For example, in Xinjiang province, it is contemplated that the first ever water project will be based on a concession agreement under the newly promulgated provincial concession regulations.

More generally though, as long as recourse to concession agreements for the implementation of infrastructure projects is not made compulsory and backed by strong incentives and a secure legal framework for private investors, China-styled BOTs will remain an important alternative to concession-based BOTs.

The
concession
model
reflects the
Chinese
government's
conflicting
policy goals.

Footnotes

- 1 Mr Suo Lisheng, Chinese vice-minister for water resources, quoted by Liang Chao in China Daily, May 6, 2005.
- 2 In the tenth five-year plan (2001-2005), more than 11 billion USD were planned to be spent in water supply and distribution, and 15 billion USD for sanitation infrastructures.
- 3 The Circular on Several Issues on Attracting Foreign Investment in the Form of BOT, promulgated by the Ministry of Foreign Trade and Economic Cooperation on January 16, 1995.
- 4 The Circular on Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign-invested Concession Projects, issued by the State Development and Planning Commission on August 21, 2005.
- 5 Issued by the Ministry of Construction on March 19, 2004, and effective as of May 1, 2004.
- 6 The People's Republic of China Contract Law, promulgated on March 15, 1999, and effective as of October 1, 1999.