

A New Framework for Foreign Investment in PRC Infrastructure



By Stéphane Vernay & Nadine Ganesan

Gide Loyrette Nouel

As China's urbanization rate continues to skyrocket, so does its demand for investment in urban public utilities. Though it is aware of the necessity of implementing a friendly investment framework to attract funding, China tends to increasingly rely on the availability of domestic funding and local expertise to develop its public utilities infrastructure. This new reality affects the creation and implementation of a new framework for foreign and domestic investment in the sector.

A concession-based framework?

From the central government's perspective, it is clear from the May 2004 promulgation of the *Administrative Measures on the Concession of Municipal Public Utilities* (National Measures) by the Ministry of Construction that public utility projects should be conducted through concessions awarded to both foreign and domestic sponsors. How quickly this will become the norm depends exclusively on the willingness and efficiency of local governments in implementing local regulations in this respect. So far, implementation is still scarce.

The National Measures put an end to an experimental phase launched in the PRC in the mid 1990s whereby concessions could be awarded solely to foreign sponsors for specific pilot build-operate-transfer projects in limited key sectors.

Until recently, most foreign investment in public utilities materialised on the basis of China's foreign direct investment

(FDI) legislation, in the absence of a general framework for the implementation of concessions. Special purpose vehicles (SPVs) would typically enter into either service-type agreements with dedicated off-takers to carry out specific projects in the sector or receive a licence or approval to operate public utilities and then contract directly with end-users.

Under the National Measures, SPVs must now validly conclude formal concession agreements directly with government entities for urban public utility projects in localities where the National Measures have been implemented.

Bidding

In accordance with the National Measures, concessions in the public utilities sector must be awarded through competitive bidding. The scope of this requirement is, however, a running source of confusion. For instance, there has been repeated disagreement between government authorities and private investors over whether additional bidding procedures must be carried out by a bidder to which a concession is awarded, for the design, procurement and construction of the underlying infrastructure. This is despite the fact that in this particular case, recent experience has shown that where a bidding consortium is composed of contractors to which these works are to be awarded, additional bidding would not be necessary, provided that the contractors are duly qualified to conduct these activities in the PRC.

In practice, though, the January 2000 *PRC Bidding Law* defines the parameters for tendering procedures and potential investors will note to what extent these tend to deviate, both in substance and in form, from international standards. Examples of this reality are the increasing trend of issuing bidding documentation and bidding in the Chinese language only, the unreliability of technical data provided on projects, the very short bidding deadlines, the requirement to sign project documents prior to financial closure and prior to incorporation of the concessionaire (leading to direct liability of the sponsors), and the governance of project documents by Chinese laws and Chinese arbitration for dispute resolution. Clearly, bidding requirements under the National Measures and the *PRC Bidding Law* need to be consolidated in order to offer a unified framework to potential investors in this respect.

Choosing an SPV

Where foreign investment is contemplated for public utilities projects, SPVs may take the form of joint ventures (JVs) between Chinese parties and foreign investors or wholly foreign-owned enterprises, depending on the specific requirements and nature of the projects.

In practice, investors should be aware that PRC foreign investment guidelines require that construction and operation of certain public utilities (namely gas, heat, water supply and drainage pipe networks in medium and large-sized cities) be carried out by foreign-invested enterprises in which the Chinese parties hold a controlling interest.

In the June 30 2005 *Implementing Opinions on Promoting the Old Industrial Base in the Northeastern Region to Further Expand its Opening Up*, the State Council announced a relaxation of this requirement in China's north-eastern provinces in an attempt to attract foreign investment. However, this market is still not widely open to foreign investment and accordingly reserved to domestic investors.

Dealing with risk allocation

While the regulatory framework being introduced for the concession of municipal public utilities is based on a set of broad principles, comprehensive project documents are still essential to safeguard the rights and interests of the parties involved. Chinese authorities have been working on draft standard concession agreements integrating, in particular, basic principles of risk

allocation usually found in international project finance. In practice, however, a certain number of risks (i.e., political force *majeure*, changes in law and hardships) continue to be difficult to allocate and negotiate with government authorities.

Counterparty risk is also a source of concern in the Chinese context, where the creditworthiness of government entities and state-owned enterprises remains extremely difficult to assess given the limited access and reliability of data and the complexity of the Chinese public accounting system.

In infrastructure projects based on off-take arrangements, take-or-pay schemes are frequently a source of concern, as they may be regarded as falling under China's prohibition on government entities issuing guarantees. Similarly, priority returns on investments used in cooperative JV structures may infringe the prohibition of fixed returns on investment guarantee. When structuring such arrangements, it is thus important to remember that the SPV must continue to bear normal operating risks to avoid falling under these prohibitions. In projects structured without off-take agreements, commercial risk is even more difficult to allocate in light of the absence of reliable forecast revenues.



Gide Loyrette Nouel

Beijing Office

Suite 3501, Jing Guang Centre, Hu Jia Lou, Chaoyang District, Beijing 100020, PRC
Tel: +86 (10) 6597 4511 Fax: +86 (10) 6597 4551 Email: gln.beijing@gide.com

Shanghai Office

Suite 2008, Shui On Plaza, 333 Huai Hai Zhong Road, Shanghai 200021, PRC
Tel: +86 (21) 5306 8899 Fax: +86 (21) 5306 8989 Email: gln.shanghai@gide.com

Languages Spoken: French, English and Chinese

Year Established in the PRC: 1993

Key Areas of Practice:

Antidumping; Banking and Finance; Business Restructuring- Mergers and Acquisition; Construction- Real Estate; Direct Foreign Investments; Dispute Resolution- Arbitration; Distribution; Industrial and Intellectual Property; Labour Law; Project Financing; Tax Law- Exchange control; Telecommunications- Internet and E Commerce; WTO