

# Reform sets model for PPPs in public utilities

Stéphane Vernay and Nadine Ganesan of Gide Loyrette Nouel discuss how the PPP structure is used in the public utilities sector and the opportunities it presents for foreign investment

Since its accession to the WTO, the Chinese central government has been gradually decreasing its level of involvement in a series of sectors traditionally controlled exclusively by the state, in particular in the area of municipal public utilities. As public funds dedicated to the maintenance and improvement of public utilities infrastructures and services are becoming increasingly scarce, many local governments are now compelled to seek private capital to secure the long-term availability of quality infrastructure and public utilities services within their territories. This reality has opened up a large spectrum of opportunities for using various forms of public private partnerships (PPP) in the Chinese public utilities sector.

## Preferred forms of PPPs

A wide range of options exists for PPPs, but the most popular forms encountered in the public utilities sector are summarized in Table 1. They are distinguished by features such as ownership of the project's assets, level of involvement of each

party in the financing and operations, and duration of the partnership. Table 2 further distinguishes these forms of PPPs in accordance with the level of private participation in the financing of a project and the level of risk borne by the private partner.

So far the Chinese experience has shown that, in the public utilities sector, public entities tend to require PPP schemes with a high level of involvement from the private partner, both in terms of financing and overall assumption of risks. This explains the dominance of projects where the private partner undertakes to finance either the construction of new facilities or the repurchase and upgrade of existing facilities, over projects where the involvement of the private partner is limited to providing technical, opera-

tional and/or management expertise and assistance.

Curiously enough, China seems to have been developing a territorial preference for certain forms of PPPs in the public utilities sector. On one hand, the less developed north-eastern and north-western regions are seeing a high concentration of greenfield projects where private investors are awarded, generally through special purpose vehicles created with local partners, build-operate-transfer (BOT) or transfer-operate-transfer (TOT) projects. On the other hand, municipalities in certain

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more developed central and southern coastal regions have recently been hosting an increasing number of partial privatizations. There, private investors have been acquiring equity stakes (whether majority or not) in existing

domestic public utilities companies, generally fully state-owned enterprises (SOE), thus taking over their current operations.

## Reforms affecting infrastructure projects

China recently reformed the regulations applicable to infrastructure projects. This reform put an end to an experimental phase launched in the mid-1990s whereby concessions could be awarded solely to foreign sponsors for specific pilot BOT projects in limited sectors.

The reform was mainly characterized by the adoption of the Administrative Licensing Law of the PRC, which came into force on July 1 2004 and the Ministry of Construction's promulgation of the Administrative Measures on the Concession of Municipal Public Utilities, which came into force on May 1 2005 (National Concession Measures).

The National Concession Measures establish the general regulatory framework applicable to urban infrastructure projects in the PRC, which include projects in water, gas or heat supply, public transportation, treatment of wastewater and garbage. These measures now constitute the only legal basis for concession

**Table 1**

Option	Ownership of assets	Financing	Operation	Average duration (years)
Technical assistance	Public	Public	Public and private	1 to 3
Management / O&M agreement	Public	Public	Private	3 to 7
Leasing	Public	Public	Private	7 to 15
Concession	Public	Private	Private	25 to 30
BOT/TOT	Private, then public	Private	Private	15 to 20
Partial privatization (joint ownership)	Private and public	Private and public	Private and public	Perpetual
Total privatization	Private	Private	Private	Perpetual



### Stéphane Vernay

Gide Loyrette Nouel

Co-head of the firm's Beijing office since 2002 and head of the firm's newly opened (2006) Hong Kong office, Stéphane Vernay has been a Gide Loyrette Nouel partner since 2003. In addition to spending eight years of his career in the firm's Beijing office, he has worked in the taxation, M&A and finance/project finance departments of Gide Loyrette Nouel in Paris. His experience includes advising government authorities and numerous foreign investors on their infrastructure projects in Europe, Africa and China, especially in the fields of energy, water, urban heat supply, and sports infrastructure construction and transportation, with a particular involvement in the preparation for the 2008 Olympic Games. He advised the Chinese government on the Laibin B and Changsha Power Plant Projects, both of which were undertakings that enabled the Chinese government to establish regulations for BOT operations. He routinely acts for clients in complex merger and acquisition transactions in China in addition to advising and assisting with direct investment, real estate and venture capital transactions. He has a highly developed expertise in French, Chinese and international taxation.

He was admitted to the Paris Bar in 1994. He holds a Certificate in Specialized Studies in Tax Law (1993), a Postgraduate Degree (DESS) in business law and taxation – In-house Legal Counsel's Diploma (1993) and an Honours degree (*Maitrise*) in business law (1992).



### Nadine Ganesan

Gide Loyrette Nouel

A senior associate based in Beijing since August 2004, Nadine Ganesan first joined Gide Loyrette Nouel's Paris office in 2002 where she practised in the firm's project finance department. Her experience in the People's Republic of China has been largely focussed on infrastructure project financing, in particular on water and urban heat supply projects, along with sports facilities projects linked to the 2008 Olympics. Her practice in China also includes

PRC foreign direct investments and M&A. In addition to project financing, her experience at the firm has covered privatization transactions and financial restructuring projects, particularly in the motorway and telecommunications sectors. She has acted both for private investors and governments in the People's Republic of China, Western Europe and Northern and Sub-Saharan Africa. Before joining the firm, Nadine Ganesan practised for nearly three years in the corporate/M&A department of a leading Canadian law firm in Montreal.

She was admitted to the Quebec Bar (Canada) in 1999 and holds a civil law degree (LLB) from the Université de Montréal (1998) and a BCom specialized in finance from HEC Montreal (1995).

projects in the PRC. Although they are drafted in general terms, they establish the basic principles of Chinese policy concerning the concession of municipal public services in the PRC and define, among other things:

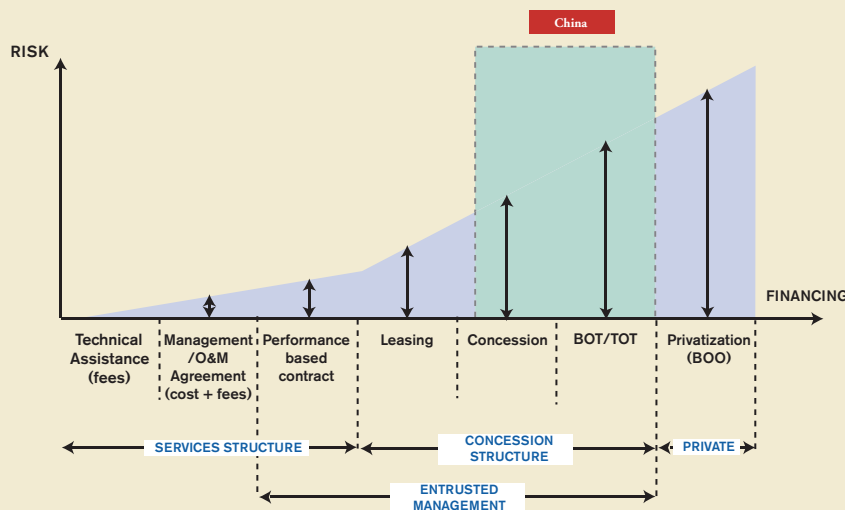
- the authorities competent for the attribution, approval and supervision of concession projects and the conceding authority (referred to as *public utility authorities* and placed under the control of the Ministry of Construction);
- the obligations in terms of competitive bidding (compulsory for the award of any concession project), the procedure and conditions bidders must fulfil to be selected;
- the modalities for the examination, supervision and control of tariffs and tariff escalation formulas; and
- the principal rights and obligations of each party (including consequences in case of changes in law, *force majeure* or similar occurrences, and early termination modalities).

The National Concession Measures do not apply directly to all infrastructure projects in the PRC and must, in accordance with the provisions of the Administrative Licensing Law, be transposed for application in the different provinces or municipalities of the PRC.

This new regulatory framework is especially relevant to greenfield PPP projects where newly established entities are attributed rights by a government authority to construct urban infrastructure and/or operate public utilities services for a determined period of time (the operating rights). Where the National Concession Measures have been locally implemented (which is the case so far in Beijing, Hangzhou, Jinan, Shenzhen, Hebei Province, Guizhou Province and Xinjiang Autonomous Region), greenfield urban infrastructure and public utilities projects must now be developed according to a concession-based model whereby the operating rights are awarded, after a competitive bidding procedure, to a special purpose vehicle (SPV) generally established between a Chinese and a foreign partner by concluding a concession agreement with the local public utilities authorities.

Where the National Concession Measures have not yet been implemented, greenfield PPP projects can still be privately negotiated and are generally structured on the basis of a more classical scheme whereby the SPV enters into

Table 2



a service agreement either with a domestic enterprise (generally an enterprise owned by the local government) or a dedicated off-taker, the contents of which are quite close to that of a concession agreement.

In principle, this new regulatory framework should not have a big impact on privatization projects because the new regulations do not affect operating rights that have already been awarded to domestic enterprises. This being said, the specific rules applicable in each municipality or province where a contemplated privatization is to take place should be carefully assessed at the early stages of a project as there might be cases where:

- certain existing domestic public utilities

entities may not formally hold any operating rights before their privatization and so need to secure such rights before the realization of the contemplated privatization to avoid a situation whereby, in theory, the operating rights would in the future have to be re-awarded through competitive bidding and on the basis of a concession scheme; or

- the operating rights of the target companies cannot, because of specific local requirements, be maintained as a result of the privatization. This could, in certain municipalities, be the case if the privatization results in a change in control of the target company or if the necessary transformation of the target company into a foreign invested enterprise (FIE), as a result of the privatization in favour of foreign investors, triggers the necessity to re-attribute the operating rights to the newly transformed entity, in which case such rights would also theoretically have to be re-awarded through competitive bidding and on the basis of a concession scheme.

### Sectorial constraints on foreign investments

Foreign investments in the PRC still remain subject to certain limitations and administrative controls that impact on

PPPs in the public utilities sector. The control and guidance mechanisms stem from the top, through the regularly amended Provisions on Directing Foreign Investment (the Provisions) promulgated by the State Council. The general indications given in this text are used as a basis for a sector-by-sector catalogue of activities open to foreign investment: the Catalogue for the Guidance of Foreign Investment (the Catalogue).

The latest version of the Provisions divides foreign investment projects into

four categories: encouraged, permitted, restricted and prohibited. It also sets a general principle of granting administrative approval authority to provincial level authorities.

Investment projects listed in the encouraged category are eligible for

preferential treatments and incentives (mainly tax related).

Of particular interest to the public utilities sector, the current version of the Catalogue classifies the construction and operation of certain types of infrastructure, such as power stations (including electric, nuclear and hydroelectric) and urban water supply plants, in its list of industries in which foreign investment is encouraged. However, it classifies the construction and operation of gas, heat and water supply and drainage pipe networks (restricted activities) in medium and large cities in the PRC (grossly cities with non-agricultural populations of over 200,000 inhabitants) in its list of industries in which foreign investment is restricted and contains a specific requirement that the Chinese Party must have a controlling interest in companies involved in these restricted activities.

The enforcement of this requirement was relaxed just last year in China's north-eastern provinces (Heilongjiang, Jilin and Liaoning), where foreign investors may now, subject to obtaining State Council approval, hold majority interests in entities involved in restricted activities, but foreign investors should bear in mind that, unless their contemplated project is in an area where the controlling interest restriction has been relaxed, their participation in companies whose business scope involves the

restricted activities will be limited to a non-controlling interest.

### Additional issues to consider

Notwithstanding the regulatory reform described above, the privatization of domestic public utilities enterprises raise additional issues, some of which are common to any acquisition project in the PRC today:

#### *Necessary reform of the target*

Foreign investors in the public utilities sector often tend to underestimate the extent to which the target public utilities entity in which they wish to acquire a stake, generally a long-standing SOE, must be reformed or reorganized before the contemplated acquisition can be made. The reorganization of the target generally aims to ensure that immediately before the privatization :

- the business of the target is limited to the provision of services related to the core business that the foreign investor is interested in;
- all core business assets are actually owned directly by the target (which is not always the case);
- all non-core business assets are removed from the target, with particular attention being paid to the exclusion of assets related to business activities in which the target might have been involved and which are classified as being restricted from foreign investment; and
- the target is a company with independent legal person status (and not a department of a government) that has secured the right to perform the activities related to its core business and that this right is retained after the contemplated acquisition is completed.

Initial discussions between foreign investors and relevant Chinese counterparts should generally aim to determine the scope of any reform or reorganization carried out by the target company. Subsequent actions to be carried out are often addressed in a preliminary agreement between the foreign investor and the target's shareholders as conditions precedent for the contemplated acquisition. Though the foreign investor will have little to no participation at the implementation stage of the target's reform, its involvement at this preliminary stage will help ensure that the reformed entity meets its investment requirements.

**The National Concession Measures now constitute the only legal basis for concession projects in the PRC**

*Mandatory evaluation of state-owned property*

Assets or equity of domestic PRC companies being transferred to foreign investors must be previously evaluated by an appraisal institution so that the purchase price for the transaction can be determined. In the specific case of transfer of state-owned assets or equity, the state-owned assets or equity must be evaluated by a qualified PRC auditing firm.

Except where a specific approval has been sought and obtained from the state-owned assets supervision authorities, the purchase price agreed between the parties for the purchase of state-owned equity must not be lower than 90% of the price resulting from the state-owned assets evaluation. The final purchase price must however, in the cases of transactions involving transfers of state-owned equity, be determined following a listing procedure carried out by, and before, a relevant Property Rights Exchange Centre (PREC).

*Listing: an alternative form of competitive tendering*

Transfers for consideration of state-owned property rights in the PRC are now, except where they involve equity interests in listed companies or financial institutions, subject to a *listing procedure* that must be carried out through a designated PREC. So the listing procedure applies in the context of privatizations of SOEs such as those involved in public utilities, unless the relevant State-owned Assets Supervision and Administration Commission (Sasac) grants an exceptional exemption.

The listing procedure requires that any transfer of state-owned property rights be publicly disclosed for a minimum of 20 working days to give any interested third party the opportunity to express its interest in the contemplated transaction. In such a case, a bidding or auction procedure must be carried out to decide to whom the underlying equity interests will be transferred. As a general rule, if only one bidder expresses its interest in the contemplated transaction, no bidding or auction is required and the transfer can be carried out through private negotiation in favour of the interested purchaser. In certain localities however, a second listing procedure might have to be carried out in such circumstances. The listing procedure should be carried out after the mandato-

ry evaluation of the equity or assets and before signing the contractual documentation for the acquisition. Any listing procedure is organized by the competent or selected PREC and carried out in compliance with its internal rules and regulations.

The conditions or requirements to be met by the final transferee are determined by the transferor at the beginning of the listing procedure for disclosure to the public. Such requirements might include conditions relating to the payment schedule, undertaking of certain debt of the target company, and the experience/financial situation/technical capacities of the transferee. The relevant PREC will determine to what extent the conditions imposed by the transferor are acceptable.

Although the current trend is to condition the involvement of private parties in the public utilities sector to some form of competitive tendering procedure (formal bid or listing), PRC laws do not yet exempt the winning bidders from carrying out further mandatory tendering procedures for the award of the design, procurement and construction of public utilities infrastructures to be built later.