

Is a New Model for Private Investment Taking Shape in the Chinese Water Sector?

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Currently, 80 per cent of China's water areas and 45 per cent of the groundwater are polluted. Meanwhile, amongst 700 cities in the People's Republic of China ("China"), over 400 suffer from water shortages year round, and it is reported that due to the shortage of water supply, up to 230 billion Renminbi (RMB) are lost every year in urban industries.

In order to tackle this urban water shortage and thus allow continuous economic and social development, Chinese authorities have decided that, during the tenth five-year Plan period, sewage treatment facilities should be built in all cities. With the rapid enhancement of China's urbanization level, there is an increasing demand for investment in the construction and renovation of the facilities in the water industry.

To face this double need, according to its ongoing policy campaign to separate the administrative and commercial functions of the government, China has been trying to attract foreign investors and to elaborate a legal framework for foreign investment in public utilities.

The first attempt dates back to 1995, when a tentative regulation providing for the build-operate-transfer (BOT) investments in public utilities was issued. At that time, the construction and operation of urban water supply and sewage networks were prohibited, while the construction and operation of water supply and sewage treatment plants were only permitted.

Since 2002, the construction and operation of urban water plants is listed amongst the activities in which foreign investment is encouraged, and the construction and operation of networks is no longer prohibited. Non state-owned capital being encouraged to enter the water and sewage industries, the need to build a legal concession framework became stronger.

With many utility industries traditionally operated by administrative utility bureaus in each municipality or county, the aim of boosting operating efficiency through private investment and operation and recasting the state as a regulator to oversee the public interest called for the enactment of a clear regulation on how private entities can enter the water sector in China.

This regulation eventually came into force on May 1, 2004. The Administrative Measures on the Concession of Municipal Public Utilities (the "2004 Measures") follow a series of documents on promotion of the market-oriented water industry that were promulgated by the State Development & Reform Commission, the Ministry of Construction, the State Environmental Protection Administration, and some provincial and city governments.

The 2004 Measures set up a basic legal framework for concession of local public utilities, providing for the procedure that has to be followed and for the main aspects of concession projects and contractual documentation. In the meantime, the Ministry of Construction (the "MOC") is currently working on a set of standard concession agreements, amongst which one relates to urban water projects (the "Draft

Standard Concession Agreement for Urban Water Project"). Being largely inspired by the concession agreements concluded in previous BOT pilot projects developed in China, the Draft Standard Concession Agreement, which is intended to be finalized before the end of the year, represents a key step toward China's move to a new model for Private Public Partnership in the water sector and provides answers to issues which, to date, remain unaddressed by the current Chinese legal framework.

1. Towards Privatisation

1.1. The First Experimental Projects

China's legislation on concession dates back to 1995, when the Ministry of Foreign Trade and Economic Cooperation (the "MOFTEC") issued the Several Issues on Attracting Foreign Investment in the Form of BOT Circular and State Development and Planning Commission (SDPC, now "reform commission" or SDRC) issued the Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign-Invested Concession Projects Circular (both circulars being jointly referred to as the "1995 Circulars").

The 1995 Circulars were issued merely to set forth the legal procedures for cautious experiments in foreign invested BOT projects in China in certain areas only (power, highways, bridges, tunnels, urban water supply plants). While in other areas the 1995 Circulars was dedicated to large size projects only, no limitation in project size was assigned for urban water plant projects, thus confirming the urgent need for a legal framework in this sector.

To realise pilot BOT projects, foreign investors had the possibility to create project companies in the form of cooperative joint venture, equity joint venture or wholly foreign-owned enterprise. Incorporation of foreign investment stock companies was not allowed, thus preventing any kind of financing through the issuance of stocks on the Chinese market.

The 1995 Circulars also provided for a comprehensive procedure for the conclusion of a concession agreement, this being a key element for the Chinese state administration to ensure control over such projects.

The SDPC was given authority to approve the preliminary feasibility report prepared by the local planning commissions and the concession contract concluded for each project. Local governments were responsible for the intermediary phase of bidding and acted as primary obligor under the concession agreement.

In practice, out of three projects launched under the 1995 Circulars, only two BOT projects were implemented in China and reached financial close: the Laibin B BOT power plant project and the Chengdu No. 6 (CN-SC-WTR-001) water plant project, China's first build-operate-transfer pilot project in the water sector.

These projects were implemented with wholly foreign-owned enterprise project companies that had been required to obtain all their debt financing overseas through foreign currency loans with no guarantee given by any Chinese domestic entities.

1.2. Projects Outside the 1995 Circulars' Frame

Due to the restrictive drafting of the 1995 Circulars, which applied only to experimental projects in some areas, other projects had to develop outside this regulatory framework.

The Beijing No. 10 water treatment plant project (**CN-BJ-WTR-011**), initiated in 2000, is the best example. While the Chengdu No. 6 project managed to achieve its financial close using purely foreign financing, during the aftermath of the Asian financial crisis, and given the fears of a RMB devaluation and lack of commercially-available long-term hedging instruments, domestic financing was relatively more attractive when the project structure for Beijing No. 10 was being decided. However, to date, Beijing No. 10 water treatment plant project has not yet reached financial close.

1.3. Attempts at Regulation

To cover the many legal questions and issues which are likely to be generated by concession projects, well-drafted regulations would have been of tremendous assistance for developers, financiers and government authorities.

The 1995 Circulars stated that the SDPC would be responsible for organizing the drafting of the "Foreign Investment Concession Projects Tentative Provisions" (the "Tentative Provisions").

The Tentative Provisions were to be issued upon the approval of the State Council and were intended to end the experiments and provide the legal basis for the general implementation of concessions in China in all areas. But such promised Tentative Provisions have not been issued till now.

Instead, the Ministry of Construction promulgated a text which, originally designed to expand the use of foreign capital in infrastructure projects, eventually failed to achieve such goal. The Utilization of Foreign Investment in Municipal Public Works Tentative Provisions (the "Provisional Regulations"), promulgated on May 27, 2000, was designed to apply to projects for the construction or renovation of facilities for urban water supply and sewage treatment.

However, this raised an issue of statutory inconsistency as, according to the 1998 Foreign Investment Industrial Guidance Catalogue (the "1998 Catalogue"), the construction and operation of urban water supply and sewage networks were listed as prohibited foreign investments. The Catalogue, as it is prepared by the State Council, cannot be overridden by a text issued by a ministry.

The scope of infrastructure projects in which foreign investment is encouraged was eventually expanded thanks to the promulgation, in 2002, of the new Guiding the Direction of Foreign Investment Provisions and the Foreign Investment Industrial Guidance Catalogue (the "2002 Catalogue").

Foreign-invested infrastructure projects in the field of urban utilities, such as sewage and water treatment plants, were included in the encouraged investment sector.

Projects in these fields can now thus benefit from the preferential treatment applicable to all encouraged industries, which mainly consists of certain tax exemptions/reductions.

The only exception relates to the construction and operation of water supply and sewage networks in large and medium-sized cities. The 2002 Catalogue still categorizes these activities as restricted projects in which the Chinese parties must have a controlling interest of 51 per cent or more.

Despite the regulatory opening-up of urban utilities, until recently, there have been no regulations addressing the numerous questions and issues such projects can generate.

2. Basic National Concession Framework

The 2004 Measures, promulgated by the Ministry of Construction and effective since May 1, 2004, follow two earlier, less authoritative circulars: the Opinion on Enhancing the Development of Urban Wastewater and Garbage Treatment Industries issued by the State Development and Planning Commission, State Environmental Protection Bureau and MOC on September 10, 2003, and the Opinion on Accelerating the Marketization of Urban Utilities issued by the MOC on December 27, 2002 (the "2002 Opinion").

The 2004 Measures offer a long awaited general administrative legal basis for the privatization of public utilities in sectors administered by local governments. They fill the regulatory void which should have been filled by the anticipated Tentative Provisions by putting an end to the experimental phase of concessions regulated by the 1995 Circulars and guiding the concession practice in China into a new stage of formal general implementation.

The main issues addressed in the 2004 Measures relate to the competent authorities throughout the concession procedure, the criteria for selecting the concessionaire, the terms and conditions of the concession agreement, as well as the rights and obligations of the parties to the agreement involved in concession projects.

2.1. Scope of Application

In comparison with the 1995 Circulars, the scope of the 2004 Measures extends to any kind of concession project in urban public utility industries, including the supply of water, gas and heating, public transportation, sewage treatment, and garbage disposal. It is no longer restricted to a number of experimental and large size projects.

The 2004 Measures do not focus on foreign investment only but rather allow concession projects to be also developed by Chinese domestic companies, thus confirming the provisions in the 2002 Opinion which allowed any entity to obtain concession rights by concluding a concession agreement with the administrative authority responsible for the concerned sector.

2.2. Competent Authorities

The MOC is responsible for the guidance and supervision of concession of municipal public utilities throughout the whole Chinese territory. Meanwhile, the competent construction authorities of each provincial government and the governments of each autonomous region are responsible for the guidance and supervision of concession of municipal public utilities in their own administrative territories.

The detailed implementation of the concession belongs to competent municipal public utilities authorities ("MPUA") that have been delegated such task by the relevant local governments.

The local governments remain fully responsible for the approval of the concession projects, and for the approval of the concessionaire upon its selection.

2.3. Bidding Procedures

In light of the guiding principles introduced by the 2002 Opinion, the 2004 Measures provide that concessions should be granted through a competitive bidding process based on the principles of openness, equality, fairness, and the priority of public interest.

Bidder requirements are rather vague: they must have a reasonable registered capital, necessary facilities and equipment, relevant experience, sound financial standing, and a

number of technical, financial and operational personnel. (See next article in this section for a detailed look at the PRC bidding law.)

2.4. Content of Contracts

The winning bidder must sign a concession contract with the MPUA which, according to the 2004 Measures, shall, in addition to the contract scope and terms, contain terms governing the service standards, maintenance of the facilities, safety management, performance guarantees, termination, liability for breach, dispute resolution, and tariff calculation and adjustment mechanisms.

Amidst these points, only one is further detailed in the 2004 Measures: the term of a concession shall not be longer than 30 years. Such a length of time is in conformity with the usual practice for long term investment return projects such as highway projects and would generally not be applicable for water project which are usually structured over a shorter duration (18-25 years).

It should be noted, however, that specific regulations may also apply to non-BOT projects. For example, under the State Development and Planning Commission's Strengthening State-owned Infrastructure Facilities Assets Interest Transfer Administration Circular issued on October 19, 1999, the maximum term of transfer of existing state-owned urban utilities is 25 years. This shorter term applies to transfer-operate-transfer (TOT) type concession projects.

Because of their somewhat vague requirements, the 2004 Measures can thus allow the implementation of any kind of project structures: mainly BOT and TOT. This is consistent with the broad definition of a concession as being the mechanism under which the governments shall select the investors or operators of municipal public utilities through market competition, and specify that investors or operators shall, within the specified period and scope, operate certain municipal public utilities.

2.5. Tariff

While the 2004 Measures do not contain any specific provisions prescribing the form of the tariff structure, therefore allowing the concessionaire to negotiate a tariff which is adjustable according to certain criteria, a clear reference is made to the rights of relevant departments to examine, supervise and control the tariff in accordance with PRC laws and regulations.

Whether or not such right extends to approval or verification of any tariff adjustment remains unclear and would need to be specifically addressed in the concession agreement in order to avoid any later interference.

2.6. Rights and Obligations

The MPUA benefits from extensive supervision and intervention power and may impose sanctions on the concessionaire. During the operation of the project, it is responsible for organizing evaluations by independent experts at least once every two years and supervising the concessionaire in the performance of its statutory and contractual obligations, with respect to the quality of products and services as well as the safety of production.

Furthermore, the concession contract can be terminated and the project taken over by MPUA where the concessionaire assigns or leases out the concession right without authorization, where it disposes of or mortgages the properties operated without authorization, and where there are serious quality problems, interruption, or suspension of service without authorization that seriously affect public interests or public security.

On the other hand, if the concessionaire wishes to terminate the concession contract, it must give notice to the responsible authority, which must respond within three months. Before MPUA agrees to terminate the concession, the concessionaire must ensure continuation of normal operations.

Of notable interest, the 2004 Measures also indicates that the concessionaire shall be provided with appropriate compensation for any loss suffered by it as a result of any government decisions made in the public interest or any default of MPUA. However, it remains unclear to what extent such principles allow compensation to the concessionaire upon the occurrence of a change in law, a political force majeure event or any termination event not caused by the concessionaire.

3. Discrepancies and Weaknesses Under the 2004 Measures

The 2004 Measures provide a general administrative legal basis for the privatization of public utilities in the sectors that are administered by local governments. Nevertheless, it only serves to provide a broad regulatory framework as they refer to local regulations for the actual implementation of concession projects.

So far, only few local governments have promulgated such local concession regulations, but discrepancies have already been noted.

Another weakness of the current concession legal framework stems from the lack of detailed guidance for many legal issues that are fundamentally relevant to private investment. It is, however, expected that the Draft Standard Concession Agreement will help in this respect and will provide appropriate guidance.

3.1. Discrepancies Among Local Regulations

As urban utilities are a matter of local jurisdiction, following the 2002 Opinion, many municipal governments have enacted their own rules to regulate utility concessions. Shenzhen and Beijing promulgated specific local regulations to address the scope, form, grant procedure, rights and responsibilities, termination and relevant government authority in urban utility concessions. Tianjin and several other cities and provinces have also set out their policies in less formal government circulars.

As might be expected from the localization of rules, Shenzhen and Beijing have come up with different methods of awarding projects. According to the Public Utilities Concession Operation Method of Shenzhen, issued on March 31, 2003, the concession can be awarded through bidding, invited negotiation or other means permitted by law, while pursuant to the Urban Infrastructure Concession Operation Method of Beijing, issued on August 28, 2003, concession shall be awarded through bidding with the exception that TOT projects may also be directly awarded with the approval of the Beijing Municipal Government.

As the 2002 Opinion did not address direct or negotiated concession grants rather than expressly prohibiting them, it left the door open for direct assignment of concessions to enterprises. This also raises a possibility of discrepancies between different local government regulations on concession and, as the MOC regulations do not prevail over local government regulations, such discrepancies will not be easily overcome.

In relation to the awarding of concessions, there is a specific state law which is applicable, namely the PRC Administrative Licensing Law promulgated on August 27, 2003 and effective from July 1, 2004. This law requires that the grant-

ing of permits in special industries affecting the public interest – such as the granting of concessions in urban utilities – shall be determined through fair competition such as bidding or auction unless otherwise provided in laws and the State Council's administrative regulations. It would thus prevent local governments from directly negotiating a concession agreement.

In general, though, in the absence of an express state law or State Council regulation, local governments are free to formulate their own implementing regulations. In the event of conflict between the MOC regulations and local government regulations, the PRC Legislation Law promulgated on March 15, 2000, provides for adjudication by the State Council.

3.2. Weaknesses of the National Framework

Prior to the issuance of the 2004 Measures, while a complete set of laws applied to domestically funded and constructed infrastructure projects, only the initial preparation period and project feasibility study report of a foreign invested project were regulated. The construction and operational phases were left to the responsibility of the parties. No criteria, except the contractually stipulated ones, would apply to the definition of quality standards and tariffs.

Thanks to the issuance of the 2002 Opinion and of the 2004 Measures, some important issues now benefit from a legal framework, including quality control, extensive governmental supervision and intervention clauses.

Concerning tariffs, although the 2002 Opinion provides for government subsidies to an enterprise in cases where tariffs are set below cost in order to meet public welfare objectives, its wording is ambiguous.

Tariffs are to be set "in accordance with the industry's average costs and with consideration given to the reasonable profits to be made by the enterprises", but the 2002 Opinion also vaguely states that "the reasonable investment returns to be obtained by an enterprise through its legal operation shall be guaranteed". It could be seen as contradictory to other PRC regulations that prohibit overt or covert guarantees under the form of fixed return on investment to foreign investors.

On this particular aspect, it is regrettable that neither the 2002 Opinion nor the 2004 Measures contain any provision on take-or-pay tariff structure. Indeed, some Chinese authorities have, in recent and particular cases, questioned whether the take-or-pay mechanisms would fall under the prohibition of fixed return guarantees.

This practice, for which compliance with Chinese law has been expressly confirmed by the State Council in the power sector, still appears to be a key condition for any financing of BOT projects in the water sector as long as the scope of the concession does not extend to the operation of public networks.

4. Future Developments: Towards a Chinese Concession model

It is estimated that 10 million Chinese people leave their villages to move to urban areas every year. This has led the government to project that China's urbanization rate will be at least 50 per cent by the year 2020, from 37 per cent in 2002. As this process of urbanization goes on, construction of urban infrastructure facilities will accelerate.

In this context, and consistent with the trend of "privatization" of public utilities, there has been an urgent need to improve the investment environment, formalize contract formation and ensure the enforceability of valid contracts.

Thanks to the adoption of the 2004 Measures, a significant step forward has been made, but questions as to the relationship between these texts and local regulations and the liabilities of each party to a concession agreement still remain unclear.

The latter issue should be tackled by the Draft Standard Concession Agreement the MOC is currently preparing. The draft version is a thirty five page document containing one hundred and fifty articles consisting of comprehensive definitions, and particular provisions on engineering design and construction, scale and operation of water facilities, water charges, termination and transfer of concession rights, defaults and damages, force majeure, and settlement of disputes.

On the salient aspect of financing and compensation rights, the Draft Standard Concession Agreement provides much more detailed guidance than the 2004 Measures.

For the purpose of project financing, it is provided that the concessionaire is entitled to assign its rights and obligations under the concession agreement to the lenders and, subject to the relevant MPPA written consent, to mortgage, pledge or lien its land use rights for the lenders rights and interests.

Moreover, to ensure the profitability of the investment, it is foreseen that events of force majeure, delays due to the failure of a government department in granting approval, and delays due to any failure of the relevant MPPA to fulfil its obligations under the concession agreement, will entitle the concessionaire to request that the concession period shall be extended so as to place him in substantially the same position as he would have been in had such event not occurred.

Compared to the 2004 Measures, the responsibilities undertaken by the MPPA under the Draft Standard Concession Agreement also benefit from a more comprehensive definition.

This includes supervising and inspecting the design, construction, operation and maintenance, and assisting the concessionaire in obtaining all approvals throughout the process. The relevant MPPA is also responsible for completing the preliminary works at its own cost.

The only important point that is still not made clear relates to the tariff definition and its rules of adjustment. It is very likely though that the final version of the Draft Standard Concession Agreement will provide for clear rules, and a take-or-pay tariff principle.

Though not legally binding, the Draft Standard Concession Agreement model should at least wield a heavy influence on local governments and, upon its issuance, will certainly lead the way to more uniform practices throughout the country.

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