Spring March 10, 2011

The Long Road to Reform——New Trend of Foreign Investment in China’s Water Supply and Wastewater Treatment Market

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By Liang Tao

In January 2007, Veolia Water, a world’s leading operator in water services, executed a share transfer agreement with competent departments of Lanzhou Municipal Government upon an international tender, paying RMB 1.71 billion in exchange for 45% stake in the Lanzhou Water Supply Company and forming a joint venture in Lanzhou, the capital of Gansu Province. Veolia Water indirectly obtained the right to supply water and provide wastewater treatment service in Lanzhou, as the newly established joint venture entered into a concession contract with the local government. This acquisition together with some similar acquisitions of water utilities by other foreign investors triggered fiercer dispute over the direction of the water utilities reform in China. Certain market participants, scholars and officials expressed their concerns over possible manipulation of water price and water treatment charges by these foreign investors in order to recover their huge investment.

The aforesaid Lanzhou case is a typical example of conflicts and tortuousness amid the reform of the China’s water supply and wastewater treatment (hereinafter referred to as the “Water Utility Service”) market. As either water supply or wastewater treatment is deemed as a public service and is closely related to people’s livelihood, the China’s central government attaches much attention to the regulation of Water Utility Service market. This area of the law evolves rapidly; the legal landscape remains complex. Therefore, foreign investors in the Water Utility Service market have been experiencing dramatic changes in foreign investment policies since the beginning of the 1990s.

Evolution of Foreign Investment Policy

The revisions to the China’s Foreign Investment Industrial Guidance Catalogue (hereinafter referred to as the “Guidance Catalogue”) can vividly reflect the evolution of foreign investment policies applicable to the Water Utility Service market. Business activities relating to the Water Utility Service are mainly composed of three parts: (i) construction and operation of water supply plants; (ii) construction and operation of water supply and drainage network; and (iii) construction and operation of wastewater treatment plants. These activities fall within different categories set forth in the Guidance Catalogue and shall be, accordingly, subject to different approval requirements, and thresholds for market entry.

According to the initial version of Guidance Catalogue, i.e. the 1995 version, foreign investors were prohibited from carrying out construction and operation of the water supply and drainage network. Hence, foreign investors did not have access to the water supply and drainage network facilities, which are the most important part of the Water Utility Service provisioning system, but during the same time, foreign investors were permitted to engage in construction and operation of water supply plants and wastewater treatment plants. During this period, single water supply plant and wastewater treatment plant became the major target for foreign investments in the Water Utility Service market. The representa-
The third version of Guidance Catalogue, i.e. the 2002 version, altered the landscape of China's foreign investment policies regarding the Water Utility Service market. In accordance with the 2002 version of Guidance Catalogue, the prohibition on the foreign investment in the water supply and drainage network facilities was lifted. Foreign investors were allowed to invest in the China’s water supply and drainage network facilities, provided, however, that Chinese party had control over the majority of the stake in the joint ventures. In addition, "construction and operation of the water supply and drainage network" was upgraded from prohibited catalogue to restrictive catalogue in the 2002 version; “construction and operation of water supply plants and wastewater treatment plants” was also upgraded from permitted catalogue to encouraged catalogue.

According to the latest version of Guidance Catalogue, i.e. the 2007 version or the fourth version, “construction and operation of the water supply and drainage network” remains in the restrictive catalogue with the restriction that Chinese party shall control the majority of the stake in the joint ventures. The latest version of Catalogue of Foreign Investment Advantageous Industries in Central and Western China (hereinafter referred to as the “Central and Western Catalogue”) issued in 2008 is a supplement of the Guidance Catalogue and applicable to 21 provinces, autonomous regions and municipalities located in central and western China. Such Central and Western Catalogue further upgrade between local governments and public services providers. Under the 2004 Concession Measure, the operators or providers of public services need to execute the concession agreements with the competent authorities designated by local governments. The concession agreements shall contain the concession scope, valid term, dispute resolution, specifications and standards of the products or services, etc. Prior to execution of the concession agreements, the potential public utility operators or public service providers have to compete with each other via public bidding, competitive negotiation, and other competition mechanisms.

As Water Utility Service is deemed as a public service, a project company directly providing Water Utility Service has to execute a concession agreement with the competent authority authorized by the local government. Under such concession agreement, the project company obtains the exclusive right to provide Water Utility Service within an agreed territory. The MHURD is in charge of the guidance and supervision of Water Utility Service concessions. The local counterparts of the MHURD are responsible for the guidance and supervision of the concessions in their administrative areas. The local governments shall select a competent authority taking charge of implementation of the concessions, including reviewing and approving the concession projects, selecting concessionaires via competitive mechanisms, and supervising the performance of the concession agreements on a continuous basis. It is worth noting that if the concessionaire wishes to terminate the concession agreement, it must notify the competent authority in advance. Although such competent authority must respond to such notification within three months, the concessionaire shall not cease to provide Water Utility Service before the competent authority approves such termination of the concession agreement. In addition, the maximum concession period for a Water Utility Service project is 30 years.

The 2004 Concession Measure also prohibits the concessionaire from creating mortgages over the project assets without the competent authority's approval. If the concessionaire breaches the foregoing provision, the competent authority shall have the right to terminate the concession agreement and deprive the concessionaire of its concession right. Therefore, prior to exploring and determining the financing mode for the project company, foreign investors engaging in the Water Utility Service market shall clarify whether the project company is subject to a limitation on creating mortgages over project assets and facilities.

Mechanics of project financing

Under the concession agreement, there are different types of financing mechanisms for the project company. Among them, joint venture and shares transfer arrangement (hereinafter referred to as "JV Mode"), transfer-operate-transfer (hereinafter referred to as "TOT"), and build-operate-transfer (hereinafter
referred to as “BOT”) represent the mainstream of the mechanics of project financing in China’s Water Utility Service market. By adopting the aforesaid three modes in turn, the foreign investors' responsibilities, potential risks, and anticipated profits grow gradually and local government’s responsibilities are reduced accordingly. It is advisable for the foreign investors to choose the most suitable modes according to the actual circumstances and project objectives.

Under the JV Mode, the local competent authority transfers the equity in the state-owned company, which is providing the Water Utility Service, to foreign investors, establishing a joint venture that executes a concession agreement with the competent authority later. Upon the execution of the concession agreement, the newly established joint venture will obtain the concession right and be qualified to provide the Water Utility Service. The JV Mode is suitable for the foreign investors proposing to engage in comprehensive service provisions including the construction and operation of the water supply and drainage network. In the Lanzhou case stated at the beginning of this article, Voilaa Water, the foreign investor, adopts the typical JV Mode to expand its business in China’s Water Utility Service market.

TOT is composed of three phrases: (i) competent authority transfers the operation rights of existing water supply and/or wastewater treatment facilities to the foreign investor; (ii) the foreign investor obtains the operation and management right within a specific period of time; and (iii) the foreign investor returns such facilities to the competent authority upon the expiration of the agreed period. In practice, foreign investors generally pay royalties to the competent authorities in exchange for access to the operation of the facilities. To recover their investment and gain profits, the foreign investors usually collect fees regarding water supply and/or wastewater treatment. Actually, TOT mode is similar to the lease of relevant water supply and/or wastewater treatment facilities under the concession agreement.

BOT is the first mode introduced into China’s Water Utility Service market and is also one of the most popular modes in recent years. Under the mode of BOT, the local government has sufficient incentive to introduce the foreign investors, as the local government doesn’t need to pour any investment in the water-related facilities. BOT can be used by the foreign investors to finance a project of water-related facilities. Firstly, the foreign investors shall be in charge of construction and building of the facilities without financial support from the local government. Then, the foreign investors operate such facilities and collect relevant fees to recover their investment. Upon expiration of the concession agreement, the foreign investors shall transfer the facilities to the local government.

Approvals regime

To invest in China’s Water Utility Service market, foreign investors shall go through various approval and filing procedures and seek for series of approvals issued by various departments of governments at state or local level. Among these authorities, the National Development and Reform Commission (hereinafter referred to as “NDRC”), Ministry of Commerce (hereinafter referred to as “MOFCOM”), MHRD, and their local counterparts take an important part in the approval regime. Authorities in charge of environment protection, land resource authority, competent water authority and so on also have impact on the entry of the foreign investment in the Water Utility Service market.

NDRC is the most important authority in the approval regime, as NDRC is responsible for approving and initiating a project. After receiving the NDRC’s approval, the foreign investors have to establish an entity or project company to hold the concession right. To establish the project company building or operating the water-related facilities, foreign investors shall pass the review process conducted by MOFCOM or its local counterparts. Upon the formation of the project company, the next goal is to get the concession right.

Prior to gain the concession right by executing concession agreement, the project company shall obtain the approval from the authority in charge of implementation of the public service concession arrangement. In general, such implementing authority is authorized by the local government. The local governments conduct the delegation case by case without a one-size-fits-all mode. For example, Tianjin Construction and Administration Commission is the implementing authority in Tianjin Municipality and Shenzhen Municipal Water Affairs Bureau serves as the implementing authority in Shenzhen Municipality.

Conclusion

In January 2011, the Decision on Accelerating the Reform and Development of Water Conservancy, the first official regulation issued in 2011, was promulgated by both Central Committee of the Communist Party of China and the State Council of China. It is a strong signal that China’s ruling party and central government are stepping up to reform the water-related market. It clearly poses opportunities for foreign investors.

According to the economic data released by Japanese government in February 2011, China has officially overtaken Japan to become the world’s second largest economy. With a vast water-related market, China has become the most attractive investment destination for foreign investors. Although the foreign investment is subject to certain visible or invisible entry barriers, we are confident to see great potentials in China’s Water Utility Service market in the near future.

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