

Part III

BOT EXPERT'S COMMENTS ON THE REGULATION OF CHARTERED OPERATION OF URBAN INFRASTRUCTURE FACILITIES

Introduction of the Regulation

The Regulation for Chartered Operation of Urban Infrastructure Facilities (“Regulation”) was published as a Directive of the Minister of the Ministry of Construction. It has 31 chapters which address issues in following areas:

It addresses principles and procedures for administrating and regulating chartered operation which includes objectives of the Regulation, scope of chartered operation governed by the Regulation, administrative functions at different levels of government in regulating chartered operation and general principles of implementing chartered operation.

It also defines what qualifications a concessionaire should have and the process of selecting a concessionaire. It specifies criteria used to assess qualifications of a concessionaire and each steps of the process of selecting a concessionaire. It also requires a concession arrangement being put under public scrutiny for a period of 20 days prior to awarding the concession contract.

The main contents of a concession agreement, as required by the Regulation, include scope and period of concession project, public services/products offered and its service standards, pricing methodology and mechanism of price adjustment, standards of maintenance, safety requirement, performance bond, change and termination of the concession, and lastly defaulting and dispute settlement.

The Regulation defines responsibilities of the concession granting agency and the concessionaire. The granting agency’s main responsibilities include reviewing costs of public services/products, monitoring concessionaire’s performance, dealing with complaints from the public and temporarily taking over the facility in an emergency which public interests and safety are in danger. Responsibilities of a concessionaire mainly include providing required services/products in quality and quantity, maintaining the facility up to required standards and accepting supervision of the government agency in charge.

The Regulation also addresses issues relating to the operation which include the term of concession, termination or revoke of the concession and assurance of uninterrupted public services.

At the end, the Regulation outlines penalties imposed for corruption and neglect actions of public servants in agencies in charge.

Comments on the Regulation

The Regulation is too general. It does not provide concrete guidance on how a concession project is to be developed and awarded, it is therefore difficult to be implemented in practice. For instance, it does not suggest a detailed procedure which the development of a concession project should follow. Neither does it distinguish Greenfield projects from selling existing projects. Depending upon the nature of project, the procedure and criteria for the project development can be very different.

The Regulation does not provide a clear cut between administrative functions and water company operations either. For instance, the Regulation sets out general qualification of a concessionaire which is difficult to address qualifications needed for specific project, which in turn should be a task of evaluation panel of a concession tendering organized for specific project. The concession agreement is the document that defines each party's responsibilities through an agreed upon risk sharing mechanism. It should be negotiated between parties involved. It's a matter of project implementation. The concession agreement can be different from one project to another. The government should only put clauses in the concession agreement to ensure that the government intended goal being achieved and that the government interests are fully protected and represented. The Regulation should therefore not focus on the content of the concession agreement itself. It should concentrate on how clearly to define the government's goal in pursuing concession projects instead. The recent administrative reform undertaken by the government aims at spinning off operation functions from the administrative functions, hence restricting government agencies only to be a supervision body whose main responsibility is to set out regulations, to monitor operation and coordinate with other agencies to ensure that adequate public services/products being properly rendered.

The Regulation does not offer a great help in coordinating different authorities in order to ensure the private sector dealing with only one representative from the government. Water industry concession touches many areas where different government agency is in charge. Without cooperation from these agencies, the MOC, in practice, can deal with only general issues relating to water sector. For instance, tariffs setting will need the pricing bureau's involvement because it is the agency that regulates price of water. Another example is that when an existing water facility is transferred under a concession arrangement to the private sector, the approval of assets sale from the State-owned Assets Supervision and Administration Commission must be obtained because it is the agency responsible for supervision and administration of state-owned assets. Although MOC will certainly has power to be leading manager of water concession projects, it can not make decisions on sale of assets and on determination of price.

The Regulation does not provide any indication of what sort of support the government will give to a concession agreement so that the private sector knows precisely what they can expect from the government when taking on a concession agreement. When the private sector is considering a concession project, support given by the government plays an important role in their assessing the feasibility of the project. By knowing what they can get, and what they can not get, from the government, the private sector would be in better position to estimate likely return on the investment which will be a key factor for them to consider whether the project will be taken. The government support to a concession project would also indicates how firmly the government wants the concession to be done, such boost the private sector's confidence in the project.

The Regulation fails to provide model documents which can be used as a guideline and reference for parties to a concession project. General descriptions like what being found in the Regulation will not resolve the discretionary actions taken by the government at different levels in the process of launching and implementing concession projects. For instance, Chapter 7 gives general qualifications of a

concessionaire. But in reality, lack of qualified water companies is the main obstacle that defers a healthy concession projects developed. Experience and skills of existing water companies are so diversified, it is almost impossible to arrive at a same standard for qualifications. In absence of standards, the government at each level can select “qualified” water companies using very different criteria. This will be against the MOC’s intention to strengthen already disordered concession projects’ implementation.

More specific comments on the Regulation are set out below:

- Chapter II: A detailed definition of Concession should be made clear and concrete. Concession should include management contract, lease assets, BOT, PPP and other forms.
- Chapter III: Due to the complexity of concession projects, the MOC should develop relevant regulations and procedures which can be used to assess feasibility of an intended concession project. A successful concession project will have to be a project that is correctly selected. Lack of feasibility of being implemented as a concession project appears to be one of reasons for unsuccessful concession projects.
- Chapter VII: The criteria should be more concrete, for instance by putting more weights on industry experiences and technical capability of designing, constructing, operating and financing public utilities. As discussed in previous section, general description of qualification will not an effective tool to bring up concession projects to the same standard.
- Chapter VIII: The procedure described in this Chapter is overly simplified. It should be detailized. Procedures such as how to assess feasibility of a concession project, how to establish public service comparator, how to assess economics of the project and public benefits should be defined. Without these steps, it is very difficult for the government to achieve the best result. If the selection process of a concessionaire is kept being fair, equal and transparent, 20 days of public scrutiny may not be necessary.
- Chapter IX: There is no description of how risks being shared between the government and the private sector. The risk sharing mechanism is the critical element in the concession agreement. It does not mention any possible supports from the government either. Such support may be necessary to attract the private sector’s participation. Step-in rights as one of most debated issues in actual implementing PPP projects in China’s past experience should be clearly defined to avoid any confusions. One of PPP project’s advantages is to offer flexibility to the private sector to come up with innovative plan which will boost efficiency of the project. To achieve this, incentives wherever possible should be previously defined in order to inspire the private sector to seek the best way to operate the facility. As far as pricing is concerned, an independent expert panel, not the government itself, should be used to assess adequacy of price charged on the services and products to

ease concerns of private investors over fairness of the assessment. Calculation of compensation in case of contract defaults should be specified.

- Chapter XI: This should be a part of the operating agreement, not necessarily being regulated by the Regulation.
- Chapter XIII: Circumstances this Chapter refers to should be clarified because it sounds that the government can ask concessionaire to offer services below a commercial price level which could scare away the private sector. A clear and detailed description of how to calculate compensation paid by the government must be defined so that the private sector can predict the likely resolution being adopted when this situation happens.
- Chapter XVI: A tendering process will be organized only if the existing concessionaire does not want to carry on the concession or the government does not want the exiting concessionaire to continue the concession. It will be additional costs if another round of bidding is required. And the existing concessionaire should be preferred candidate because of his in depth knowledge of the facility.
- Chapter XVII: Terms and conditions for early termination should be laid out and compensation to the other party by the party that call for early termination should be defined. An early termination procedure should be defined with particular focus on evaluation of facilities, services/products, contingent liabilities and impact on continuity of services/products.
- Chapter XXI: Evaluation should be done when it is needed. Routine evaluations should be avoided because it could be an additional burden to private investors. If performance dropped significantly (causing public concerns), evaluation should be carried out. The procedure of evaluation should be defined and formation of evaluation panel should be agreed beforehand.
- Chapter XXII: An independent expert panel should be selected to evaluate pricing on services/products. Based on the recommendations of the independent expert panel, the government can grant the increase/decrease of price accordingly. If the government wants to set a lower price, private investors should be compensated for the difference.
- Chapter XXV: The revoke of concession rights followed by the government take over of the concession project should be defined in the concession agreement. It is therefore no need to hold a hearing. Defaulting the concession contracts by the concessionaire will be sole reason to revoke the concession rights.

Recommendations on amendment of the Regulation

Establishing accordance with existing laws and regulations will be a critical aspect of effective implementation of a new regulation. When drafting a new regulation, lots of attention should be given to how new regulation would be in accordance with existing laws and regulations which can have each piece of relevant laws and regulations come together to form a seamless regulatory framework. New regulation should be connected with the existing legal system. In this way, the entire legal system will become a comprehensive piece of laws which can best reduce confusions among different pieces of laws. The Regulation should not create confusions to the private sector regarding appropriate laws and regulations should apply to concession projects. The granting agency and the private sector will be parties to sign the concession contract which is protected by the Contract Law. Any overlapping clauses between the Regulation and the existing laws and regulations should be avoided so that no confusions are generated. The same would apply to Chapter VIII. The PRC Tendering and Bidding Law will have to be followed for any tendering. If the Regulation calls for a tendering for selecting a concessionaire, it merely refers to the Tendering and Bidding Law for the concrete rules and procedures. The Regulation itself should not create a new procedure which bidders might be asked to follow.

The Regulation should be issued in cooperation with all other relevant government agencies involved. This will create a single interface between the government and the private sector. Past practice showed that one of difficulties faced by the private sector is to get every government agency involved working together. The MOC should assume such responsibility to coordinate various government agencies and to install a working scheme which can easily bring all agencies together for a specific project. Through such a scheme, the private sector would only deal with one agency which can represent all government agencies involved as a whole. This will reduce project development costs and boost the private sector's confidence towards the MOC's capability of managing a project. Unfortunately, the Regulation does not consider this aspect.

The Regulation should set out clear procedure for the government to conduct its own analysis of how feasible a concession project will be. The government has inherent responsibility of quality and quantity. Terms and conditions under which the government awards the concession contract must be carefully defined and clearly laid out. For instance, how project risks will be shared between the government and the private investors and what the government can offer to private investors (lands using rights, rights of way, distribution network (if not included in the project scope, etc.)). The government should follow the defined procedure to establish a business case for the intended project. The government then needs to study options available for achieving the same objective and compare these options. Only when benefits of adopting a concession arrangement are clearly demonstrated, the government can go into tendering process to select desirable concessionaire.

One aspect the Regulation should address is to facilitate the creation of qualified water companies which can take on concession projects in a proper way. This is a challenge the government is facing in its pursuit of adopting concession arrangement. A three-stage approach could be adopted. In Stage I, the government would encourage mergers among experienced state-owned water companies to allow non-state-owned

companies to get into the industry. It would also encourage joint ventures between foreign and local water companies to create opportunities for water companies to learn good management experience from the better performed companies. In Stage II, the government should, through policy making, help incubate private water companies which could compete with existing water companies. The independent power plants in the US were developed mainly because of the Energy Act PURPA. In Stage III, the government should create a platform on which all water companies will compete with each other. As a result, the industry could be decentralized, efficiency could be increased and additional funding could be absorbed.

Another immediate action the government should take is to create model document to be used as a guidance for concession projects development. Based on result of project analysis, objectives sought by the government, environment in which the project is intended and likely support from the government, a comprehensive model document should be developed and then used for selected projects. This will set up a road map for the following concession projects and when more and more concession projects being tried under the same framework(using model document), a standard for concession project development will likely be emerged.