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PPP in China: A New Regulation on Concessions Coming into Effect on 1 June 2015

The Regulation on Infrastructure and Public Utility Concessions (the "Regulation"), recently approved by the State Council and collaboratively released by the National Development and Reform Commission, Ministry of Finance, Ministry of Housing and Urban-Rural Development, Ministry of Transport, Ministry of Water Resources, and People's Bank of China, will come into effect on 1 June 2015.

The Regulation comprises 8 chapters and 60 articles and contains detailed regulations concerning the entire process, from project initiation, selection of the concessionaire, terms of the concession contract, operation, variation and termination of the concession agreement, supervision and administration by the public sector during the concession period, dispute resolution and the legal liability of the relevant parties. The Regulation aims to consolidate and refresh the various existing rules and regulations on concessions and encourage private sector participation in the financing, construction and operation of infrastructure and utility projects.

The Regulation has a number of highlights as follows:

- **Concession Sectors:** The Regulation applies to concession activities in infrastructure and utilities within the territory of China. By way of example, it names the energy, transportation, water resources, environmental protection and municipal works sectors. The Regulation marks a considerable expansion of the permitted sectors compared to the old concession regulation issued by the then Ministry of Construction in 2004 (Rule No. 126) which only applies to urban utilities.

- **Concession Models:** The Regulation lists Build – Operate-Transfer (BOT), Build - Own – Operate-Transfer (BOOT) and Build- Transfer –Operate as three main concession models but its leaves the possibility for other models that are allowed by the State to be used. This "catch all" is very characteristic of PRC regulations - however investors should not view it as promising that other models can be proposed and will be accepted by the government without challenge.

- **Concession Term:** The Regulation retains the current regime's maximum term of 30 years but has provided an exception for "large scale investment projects" for which the Government and Concessionaire may agree a term longer than 30 years. However there are no rules to specify on what criteria must a project meet in order to qualify as a large scale investment project. Again – investors should be extremely cautious in assuming that longer terms will actually be approved in practice in unless there is considerable active, high level central government support for the project.

- **Pricing Mechanism**: The Regulation allows the public sector to permit the concessionaire to charge fees to the end users and it also allows the government to give Viability Gap Funding subsidy to the concessionaire.

The following issues arising from the Regulations may need further clarification from the government.

1. Foreign Concessionaire

According to Article 3, the public sector is allowed to enter into concession contracts with entities either incorporated in the PRC or outside the PRC. This seems to suggest that a foreign sponsor may not need to incorporate a project company within the PRC to enter into the concession contract and undertake the project. However, in practice, there might be practical difficulties for non- PRC concessionaire to acquire the land rights, import equipment and goods and handle taxation. More generally, the fact that the project is concession will not exempt it from any of the regulations governing foreign investment into China.

2. Government Commitments

Certain types of government commitments are specifically provided for under this Regulation, for example:

- Non-Competition Covenants: Government is allowed to promise contractually not to undertake any unnecessary projects which may compete against,

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or prejudicially affect, the concession project. Note the key reference to "unnecessary" projects - Local governments will probably be very careful about the possibility of fetter their ability to develop infrastructure through contracts with a concessionaire.

- Subsidies: Article 25 encourages government to set up funds with financial institutions, and explore different ways to support the concession projects, such as investment grants, financial subsidies, discounted loans, etc.

- Ancillary services and facilities: e.g. Government may be obliged to provide ancillary services and facilities pursuant to concession agreements.

However, government bodies are not allowed to guarantee fixed investment returns to the concessionaire. It remains to be clarified what will be deemed as guaranteeing fixed investment returns – would an availability based payment which shifts the market risks back to the public sector be treated as guaranteeing fixed investment returns? Logically it should not because, provided the availability payment left other risk (operating performance for example). Investors also need to monitor the implication of this mechanism - there are risks of cautious government bodies insisting on overly one-sided contracts because of a fear of being seen to offer such guarantees. - There is also the possibility of governments that have entered into contracts that an investor would view as favourable, later seeking to evade liability by claiming that the concession contract violated this prohibition. Investors should seek legal advice on this particular issue sooner rather than later in any process.

3. Simplification of Procedure

According to Article 22, relevant regulatory entities are to simplify the procedures of planning and site selection, land usage, and project approval, etc. are obliged to simplify formalities and shorten the time period. However it remains to be clarified as to "how"? The procedure of dealing with various government entities to develop projects is complex in China. To implement this provision effectively, many relevant laws rules and regulations will need to be amended, for example, land management law, construction law, etc. Given the complexities of the laws and the various vested interests (particularly at provincial government level), Investors can be only cautiously optimistic about the effect of this provision. There is the possibility that an active and supportive provincial government could use this in order to iron some of the local difficulties that an investor might experience with the approval process.

4. Financing

Under this Regulation, various financial measures are introduced to positively broaden the financing channels:

- It is allowed for policy or development finance institutions to provide tailor – made credit support to specific projects, with loan terms of up to 30 years.

- The Concessionaire will be allowed to create collateral on the receivables of the project to secure the loan to finance the concession project.

- The Equity investors are encouraged to create industry funds to invest in equity of the project company.

- It is also encouraged to utilize various funding tools to finance concession projects, such as private equity, corporate bonds, revenue bonds, project bonds etc.

In addition, many provisions of the Regulations take into consideration the rights of lenders in project finance structures. For example, in Article 38, it is provided that early termination of concession agreement may be permitted with lender's consent. Although the wording is still wide and vague, government do take into account lenders' likely concerns and show that it is aware of the importance of "bankability". What remains to be seen is the feedback from the financing market to the PRC domestic PPP market - are Chinese banks fully prepared to adopt non or limited recourse financing models for concession projects to be implemented under the Regulation?

Experience has shown that Chinese banks have funded vast amounts of infrastructure development but usually generally on a "corporate" basis. Even if a financing has been structured as a project lending the banks have tended to look to express or implicit support from their corporate relationship with sponsor companies. The extent to which a proper project financing banking market (particularly in terms of provision of serious support for bidding companies) develop is an area of uncertainty.

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