

Abortion of Political Achievement Projects

— Twist-and-turns of Shenyang No. 8 Waterworks

PPP Case

1. Background

1.1 Ups and Downs during the Economic Development of Shenyang City

Shenyang is the provincial capital of Liaoning province. Before China's reform and opening up, Northeast China had always been considered as the most important area of the republic. It was once awarded the titles of "Northeast King", "Oriental Ruhr" and "Equipment Base of China". However, since 1980s China has adopted the regional development strategies characterized from the South to the North and from the coastal areas to the hinterland to promote the incremental reform, which has gradually bereaved the advantages of the old industrial base dominated by state-owned economy. In 1980s, GDP of Liaoning province was twice that of Guangdong province; however the GDP of Guangdong in 2002 was almost twice that of Liaoning, equal to the total GDP of the three provinces in Northeast China namely Liaoning, Jilin and Heilongjiang.

The economy of Liaoning has always been marked by two distinctive features. One is the high proportion of state-owned economy. By the end of 2001, state-owned economy accounted for as much as 78.2% of the total in Liaoning, 17.4% higher than the national average level. The other feature is the high percentage of non-performing loans. By the end of 2002, the percentage of non-performing loans from city commercial banks in Liaoning was 17% higher than the national average level.

The economy of Shenyang, once the "Northeastern King", was moving downwards together with the economic status of Liaoning and Northeast China. Asset stocks of Shenyang accumulated to RMB 100 billion, accounting for 1/3 of the whole province with its GDP accounting for 1/4. In 1996, state-owned capital accounted for nearly 70% of the total social capital in Shenyang city. The proportion of non-state-owned economy in Shenyang was 9% lower than the average level in coastal areas, and the proportion of economic growth rate was almost 5% lower than that in coastal areas. Overweight of state-owned economy has restrained the development of other economies in Shenyang, and as a result, it was difficult to root out the rigidity of people's opinions on business and employment.

State-owned enterprises suffered from both high debt ratio and low efficiency. In 1996, state-owned capital accounted for nearly 70% of the total social capital in Shenyang city, while the increment created by the state-owned economy accounted for only 38% of the GDP of the city. Besides, seen from various industries, the debt to assets ratio of state-owned enterprises was higher than the average ratio in each industry, and the increment to net assets ratio of state-owned enterprises was lower than the average level in each industry. Furthermore, many state-owned industrial enterprises suffered from great loss and struggled on the edge of insolvency. They not only failed to make contributions to the development of local economy but also increased the social burden on the government.

Compared with coastal areas in the southeast, state-owned economy in Shenyang accounted for a much higher percentage in the city's social economy, but its key economic indexes were increasingly lagging behind, compared with other cities of the same level in the coastal areas. The growth rate of the government revenue was much lower while its financial expenditure percentage of GDP was much larger than that of the coastal areas. Obviously, non-state-owned economy, including foreign investment, was the driving force for the rapid economic development in the coastal areas. In 1994, the GDP of Shenyang was RMB 53.47 billion yuan, the fiscal revenue was less than RMB 3 billion yuan, and the foreign investment that had been utilized was USD 810 million yuan. Compared with mid and large-sized cities in the coastal areas, the introduction of foreign investment was explicitly much lower (see Table 1 and Table 2).

Table 1: Key Economic Indexes of Shenyang in 1994

	GDP	Actualized Foreign Investment	Local Finance	
			Income	Expenditure
Amount	RMB 53.47 billion	USD 813.29 million	RMB 2.96 billion	RMB 3.42 billion
Growth over the same period %	12.4	44	23.4	21

Table 2: Utilized Foreign Investment and Foreign Trade of Key Cities in 1994 (unit: \$ 100 million)

	Beijing	Shanghai	Tianjin	Guangzhou	Xiamen	Shenzhen	Dalian	Shenyang
Actualized foreign investment	19.5	82.7	17.8	20.4	12.41	17.3	10.9	8.13
Turnover of Import & Export	40.13	362.46	161.67	73.87	54.9	349.8	37.1	12.26

The burgeoning non-state-owned economy as well as the increasing resident and local financial income in the coastal areas have solicited both envy and admiration of the central and west areas and northeast areas. Various governments have realized that the introduction of private capital and foreign investment was the ultimate way out for the development of the local economy and the wealth of the local people. Therefore, driven by this earnest catch-up aspiration, governments at various levels across the country waved a tide of “introducing external capital”, and the amount of foreign investment has become one of the key criteria in the evaluation of political achievements of government officials. As an old industrial base and once the “Northeast King”, Shenyang was not going to accept its weakening economic status, which was echoed by its government’s aspiration to catch up. Introduction of foreign investment was considered as the most effective solution. In February 1995, Zhang Rongmao, the Mayor of Shenyang then promoted introduction of foreign investment to a strategic height in his Work Report of the Government, proposing to “aim at international market, make big efforts to develop great products and great projects that have great driving force and great influence and also represent the image of Shenyang, and also attract foreign investment by making full use of asset stocks”, “continuously improve foreign investment structure and guide foreign investment into information consulting, intermediary services, financial & insurance as well as infrastructure and resource development projects” (Yearbook of Shenyang 1995 (August, 1995), published by China Statistics Press).

As an old industrial base, Shenyang also witnessed the aging of its urban infrastructure and public facilities due to the lack of investment, which were increasingly lagging behind those in the open coastal areas. As a result, this undeveloped infrastructure seriously hindered the city’s efforts to introduce foreign investment. If Shenyang intends to improve its investment environment, the first concern should be the increase of its investment in and the improvement of infrastructure; therefore, it was quite right for the city government to issue the guiding policy of setting infrastructure as the main projects for the introduction of foreign investment, which was also in line with the policy orientation of reform and opening up as issued by the central government.

As early as 1980s, China has been gradually opening up its infrastructure to foreign investment as planned. On April 24 1983, officials from the State Planning Commission sent out explicit information through media that China would consider adopting BOT mode to introduce foreign investment into China's infrastructure.

In June 1984, Shenzhen people's government established Shenzhen Special Zone Electric Power Development Company (SED) as the cooperative body with foreign investors for the construction of Shajiao B Electric Power Plant. On June 18, 1984, Shenzhen signed an agreement with Hong Kong Hopewell Group, which was immediately approved by Shenzhen government and Guangdong provincial government. Li Peng, Gu Mu and Yao Yilin from the central government themselves showed concern for this project. On March 8, 1985, SED and Hong Kong Hopewell Electric Power Co. Ltd. (HKHEC) formally signed the contract for the construction of Sino-Foreign Shenzhen Shajiao Fossil Fuel Power Plant through BOT mode. The operating term is 10 years, starting from the completion of the construction of the project. In 1988, the project was formally put into operation. On February 28, 1995, HKHEC and Shenzhen Energy Group started to prepare for the transfer of the project, which was successfully accomplished on August 1, 1999.

Shajiao B Electric Power Plant project is the first pilot project carried out by the Chinese government in terms of reform and opening up in infrastructure industry. The central government attached great importance to it and key leaders from the central government including Li Peng and Yao Yilin themselves showed concern for the progress of this project. After the project was put into production, it was very successful in its operation. Valuable experience has been accumulated in the field of opening up to foreign investment through concession mode, and the confidence and resolution of the Chinese government on the reform and opening up of infrastructure and public utility was also strengthened.

While formulating the "Eighth 5-Year" Foreign Investment Introduction Plan, the State Planning Commission proposed the idea of promoting BOT investment mode in China. In 1993, China started to study how to standardize the introduction of BOT investment as well as the exploitation of new BOT experimental projects. World Bank and Asian Development Bank also showed great enthusiasm in promoting this issue. In 1994, these two banks held two thematic seminars in Beijing together with the State Planning Commission to provide technical support and assistance. In May 1994, 1st China BOT Investment International Seminar, hosted by the State Planning Commission and sponsored by World Bank and Asian Development Bank, was held in Beijing, during which, foreign experts and investors introduced their BOT successful experience and lessons while the State Planning Commission provided some introductory information for a batch of new infrastructure projects. In November 1994, the State Planning Commission and the World Bank held in Beijing an international symposium on the policy of promoting foreign direct investment into infrastructure projects, during which discussions were focused on BOT investment

policies and suggestions. United Nations Industrial Development Organization specifically provided technical assistance for the research and the establishment of legal framework of BOT investment in China. It also sent an expert group to help compile legal documents for China's BOT investment, in particular, the compilation of concession contract.

The State Planning Commission wrote introduction of foreign investment through BOT into its "Eighth 5-Year" Foreign Investment Introduction Plan.

On May 8, 1995, Guangxi Laibin B Electric Power Plant, Changsha Power Plant, Chengdu No.6 Waterworks were approved by the State Planning Commission as BOT pilot projects. Meanwhile, the central government also tried to introduce foreign investment into infrastructure projects and standardize the concession operation.

On January 16, 1995, the Ministry of Foreign Trade and Economic Cooperation promulgated *Notice on Relative Issues Concerning Introduction of Foreign Investment through BOT*, which was closely followed by *Notice on Relative Issues Concerning Approval and Management of Trial Foreign-invested Concession Projects* promulgated by the State Planning Commission, the Ministry of Electric Power and the Ministry of Transportation. It was stressed in these notices that, "Concession projects are new in China, so they must be carried out in a steady manner. To prevent a general rush action, pilot projects should first be carried out to gain experience before this mode is gradually promoted" and "The governments generally should not make any guarantee or commitment in any form for any projects. If a certain project requires guarantee, approval from relative state supervisory departments should be obtained before any commitment is made to the foreign side." Relative regulations in the aforesaid regulatory documents indicated that, although the central government held positive attitude towards the opening up of infrastructure industry to foreign investment and certain experience has been gained, the central government was still worrying and extremely precautious, and hoped to gain more experience through more pilot projects. In this aspect, the central government has adopted its usual strategy, which is characterized by pilot projects – experience review – expanded pilot projects – experience and lessons review – standardization and promotion.

Seen from the BOT practice during this period of time, the first and foremost purpose for the Chinese government to try to open up its infrastructure industry was to solve the fund bottleneck problem encountered in the infrastructure development.

In the old industrial base like Shenyang, state-owned enterprises were not performing well with a high debt ratio and it was hard for them to get loans from banks, neither was it easy for them to raise funds in the capital market. Meanwhile, non-state-owned economy (including private capital and foreign investment) was extremely undeveloped. Therefore, since the government financial income was drying up and the fund bottleneck problem in infrastructure construction and improvement as well as

the economic development was more serious than anywhere else, the local governments placed great expectation on the introduction of foreign investment.

For Shenyang government who was eager to introduce foreign investment so as to develop its local economy, a successful practice was urgently needed to play a demonstration role; therefore, it was imperative to select one from so many state-owned enterprises for this practice. No. 8 Waterworks of Shenyang Waterworks General Company, which was built with loans from the World Bank and which was the largest, most sophisticated water factory with the best water quality, became one of the first choices for the foreign investment introduction project of Shenyang government.

1.2 Brief Introduction of Shenyang Waterworks General Company (SWGC)

Since regional public facilities for water supply were established in Shenyang city in 1915, years have passed up to now. Before the listing of Shenyang Public Utility Holding Co. Ltd. in 1999, SWGC has become a large-sized state-owned city water supply enterprise with its businesses integrating water production, water supply operation, network maintenance, secondary pressuring as well as the inspection, design and construction of water supply projects. It sold over 1.5 million m³ of water per day, with the 2580 km-length water supply pipelines and supplementary pipelines in total, 850,000 water meters installed and the total population served of 3.5 million in an area of 185 km². SWGC, a local enterprise fully owned by Shenyang government, and also the largest water supply enterprise in Northeast China, owes 1 surface water disposal plant, 7 underground water disposal plants and 366 water source production wells. Its water supply capacity is around 1.5 million m³ per day.

Despite a heavy burden inherited through history and a low price of water supply, the company is still making a nice profit. There are 8,000 working employees but also 2,000 retired ones; the water supply price in Shenyang is much lower than that in Beijing or Shanghai, i.e., resident water price is RMB 1, secondary pressure fee is RMB 0.20 and water disposal fee is RMB 0.40. However, the company still makes a profit of RMB 10~20 million per year. At present, SWGC possesses over RMB 4 billion state assets with its net assets over RMB 2 billion.

1.3 Brief Introduction of Sino French Water

Sino French Water Investment Co., Ltd. (hereafter called Sino French Water), a joint venture established by Ondeo Water and Hong Kong New World Infrastructure Co., Ltd., is one of the largest water groups in the world. Its main business is to make investment in China to build and manage water factories. The company entered into China in early 80s and by the end of 2003, it had established 16 JV companies in China (located in Shanghai, Chongqing, Shenyang, Zhengzhou, Nanchang, Qingdao, Zhongshan, Dongwan, Changtu, Siping, etc.). Besides, it also provides technical and

operation services for water companies in China. Its total investment exceeded USD 188 million and its water supply capacity reaches 3.23 million m³ per day, serving over 10 million populations. Ondeo Water, the mother company of Sino French Water, is the world No. 1 water company. It is an affiliate company dedicated to water service fully owned by Suez Group and it provides drinking water for over 115 million people and drainage service for 70 million people. It has over 60,000 industrial clients and has participated in the construction of as many as 10,000 water facilities. Suez Group, the mother company of Ondeo Water was founded in 1880 and it is the third largest company in France, ranked 70th among the Fortune 500 in 1999. Now, it has USD 851.129 billion of total asset, USD 348.735 billion of yearly sales revenue and USD 1.119 billion of profits as well as 220,000 employees in total.

On the one side stand Shenyang government and SWGC, its fully owned company, who are over-anxious to get quick results but lack experience in introducing foreign investment into infrastructure industry, while on the other side stands an international water giant who is quite experienced and eager to occupy the Chinese markets. Between these two unmatched sides, an extremely unfair combat on the property rights of the newly founded No. 8 Waterworks got started.

2. Process

From the year of 1995 when Sino-French Water took over the property rights of No. 8 Waterworks and set up a joint venture with Shenyang side, till now when No. 8 Waterworks returns to SWGC and is operated by the latter, several key stages have been involved during just a few years including co-investment, repurchase, listing and delisting.

Stage 1: Selling Property Rights and Setting up JV

No. 8 Waterworks uses the quality surface water from Da Huofang reservoir. Built with a total investment of RMB 250 million, it is a key “Eighth 5-Year” project of Shenyang. In 1995, SWGC built No. 8 Waterworks (Li Bayan Water Factory) with a daily capacity of 400,000 tons and the total investment in this factory is RMB 250 million. It was also the largest and most sophisticated water factory of SWGC with the best water quality. It was completely constructed with loans from the World Bank. In order to raise more funds for city infrastructure construction, Shenyang government decided to sell half of the property rights of No. 8 Waterworks to Sino-French (Hong Kong) Water Investment Company. Shenyang Sino-French Water Supply Co., Ltd. was registered with a capital of RMB 250 million yuan. Both sides shared the profits as well as undertook the risks and losses at a proportion of their contributions in the registered capital. Party A, SWGC possessed 50% of the shares by contributing real properties while Party B, Sino-French (Shenyang) Water Investment Co., Ltd. held the other 50% by investing in dollars at a value of RMB 125 million. The term of this joint venture is 30 years. During the first 20 years, Side B will take the leading

role in the operation and management while during the remaining 10 years, it will be Side A. The joint venture will use by means of lease, other existing assets that are not included into Side A's investment (buildings for taking water from Fushun Da Huofang reservoir and water supply pipelines to the water factory). During the first 18 years of the JV term, the yearly rental is set at 9% of the total assets (around RMB 300 million) and no rental will be collected for the last 12 years. So the average rental rate for the 30 years is 5.4%.

All the water produced by the JV will be purchased by SWGC. The price is calculated at 110% of the water production cost which will be confirmed by both sides each year and reported to supervisory departments for approval. The first year during the operation is trial period and is not included in Side B's ROI term. Flow bonus equal to 10% of the total cost will be given to the JV by the government, which will be given back to the government without any interest calculated when the JV term expires. From the 2nd year to the 3rd year, ROI for Side B is 12% (with an amount of RMB 30 million); ROI from the 4th year to the 5th year is 15% (with an amount of RMB 37.5 million); ROI from the 6th year to the 12th year is 18% (with an amount of RMB 157.5 million); ROI from the 13th year to the 50th year is 18% (with an amount of RMB 405 million); the total return for the 30 years will be RMB 630 million, 5.04 times that of the investment. Difference arising from exchange rate of ROI will also be calculated as cost. ROI should not be less than 18% after the 13th year and half of the return should be paid in US dollars while the exchange rate risk of the other half shall be undertaken by Side B. When the JV term expires, its fixed assets will not be liquidated; instead, all the fixed assets of Side B will be transferred to Side A at a total sum. Current assets will be distributed to Side A and Side B at a proportion of 70% and 30% respectively. Early termination of the operation term or cancellation of contract should be unanimously approved by the board of directors meeting and reported to the original review & approval institutions before the board of directors proposes to liquidate the assets by liquidation committee. The assets (including the increment) will be distributed to Side A and Side B at a proportion of 70% and 30% respectively. This joint venture formally signed joint venture operation contract on April 24, 1995 and started its operation on January 1, 1996. During the first year, it produced 139.21 million m³ water, realized a sales revenue of RMB 147.1707 million (actual unit price is RMB 1.057/m³), turned in a rental of RMB 4,576,800, made a profit of RMB 24,473,900, extracted RMB 1 million of welfare funds, reward funds and reserve funds, realized a current capital of RMB 3,847,000 and both sides shared a profit of RMB 19.957 million.

Seen from the profit distribution, since the water sold to SWGC is priced at water production cost plus 10%, the net profit per year will be RMB 19.957 and 30 years of operation will generate a profit of RMB 598.5 million, which will be 4.78 times of the initial investment totaled at RMB 125 million. If the total gains from ROI are calculated at RMB 12.285 million, there gains of foreign investment will be pretty

huge. However, SWGC suffered great loss from this because they had to pay an extra fee of over RMB 20 million per year for the water it purchased from the joint venture water factory.

It is also defined in the contract that the term of this joint venture is 30 years, and during the first 20 years, personnel from the foreign side will take the position of General Manger while personnel from the Chinese side will take the position of Board Chairman, then during the last 10 years, vice-versa. Return on investment, as regulated in the contract, is 18.2% in average and 21% in maximum. SWGC will buy all the water produced and the water price and quantity will be set according to the regulated ROI, water supply plan agreed at the beginning of each year and the actual water resource cost. Employees of the waterworks are all listed in the payroll of the joint venture.

Key leaders from Shenyang government acted as the main negotiators during the whole negotiation. From the very beginning, foreign investors have been directly contacting high-level officials from the government. The leaders would set the directions, and then appoint responsible officials from the Construction Commission to negotiate with foreign investors on behalf of the city government. The whole process of negotiation was carried out between foreign investors and government officials without involving SWGC. At that time, there was no precedent of introducing foreign investment into China's water industry through PPP mode. The State Planning Commission has just listed Chengdu No. 6 Waterworks as a BOT pilot project, and before this, BOT pilot projects were focused on other infrastructure such as electric power and transportation. Therefore, as a whole, China was in extreme want of BOT knowledge and experience. However, starting from the Shajiao Electric Power Plant pilot project, some professionals in China have obtained BOT-related professional knowledge from various channels and in November 1993, Beijing Botuo Investment Development Co., Ltd. was established which was considered as China's first BOT investment consulting company. However, Shenyang government didn't follow the international normal practice to hire intermediary agencies such as investment consulting agency and law firms, etc. The Chinese negotiators didn't have any international experience in handling similar projects. Besides, Shenyang government only negotiated with Sino-French Water during the whole process with no other foreign investors as alternatives. Therefore, starting from the very beginning, the foreign side not only dominated the whole negotiation process, but also encountered no competition from others while the Chinese negotiators had to deal with the political pressure of fulfilling the foreign capital-inviting tasks assigned by their leaders

During the process of this project, Shenyang Construction Commission who was responsible for the negotiation didn't evaluate the project risks, nor did they possess any BOT-related expertise. Legal documents were all drafted by the foreign side. They had their fixed return guaranteed in the contract in which however, no

provisions were included to guarantee the benefits of the Chinese side (no regulations on Shenyang side's termination of the contract). On the other side, all the requirements proposed by the foreign side have been satisfied and guaranteed in the contract. Therefore, the rights and obligations of both sides as regulated in the contract were not reciprocal at all

Stage 2: Termination of JV and Repurchase

Successful invitation of foreign investment into No. 8 Waterworks greatly inspired Shenyang government's resolution and confidence in reforming public utility system. In 1998, Shenyang government started to carry out reform of public utility management system according to its plan by accelerating the industrialization of public utility, reforming the investment and financing system in public utility, adopting market-oriented operation, reducing government investment, opening up public utility property rights and introducing private capital and foreign investment. According to the strategic plan of the city government, Shenyang government set up Shenyang Water Co. Ltd. (hereafter called "Shenyang Water") and incorporated 7 Waterworks owned by SWGC except for No. 8 Waterworks into this company in 1998.

Shenyang Water, together with Shenyang Jingwei Passenger Transportation Co., Ltd. (public transportation) and Shenyang Shenhai Thermoelectricity Co., Ltd., formed Shenyang Public Utility (Group) Co., Ltd.

On July 2, 1999, the Group initiated and set up Shenyang Public Utility Holding Co., Ltd. (Shenyang Public), with main business centered on city water supply that was supplemented by the sidelines of thermoelectricity and long-distance passenger transportation. It's planned that Shenyang Public would get listed in Stock Exchange of Hong Kong (HKSE). For the above purpose, Shenyang government decided to integrate the quality assets of No. 8 Waterworks into Shenyang Public. After arduous negotiations, Sino-French Water acceded to Shenyang's request to repurchase its equity of No. 8 Waterworks at a high price they were satisfied with. According to the arrangement of Shenyang government, Shenyang Water paid RMB 150 million for the equity of No. 8 Waterworks held by Sino-French (Shenyang) Water. Besides, Shenyang Water also signed *Technical and Operation Service Agreement* with Sino-French Water. According to this agreement, Sino-French Water shall provide technical and operation services to the 8 Waterworks owned by Shenyang Water, who in turn, shall pay RMB 5 million per year for the following 10 years, and Shenyang Water shall pay RMB 10 million as penalty in case of breach of contract.

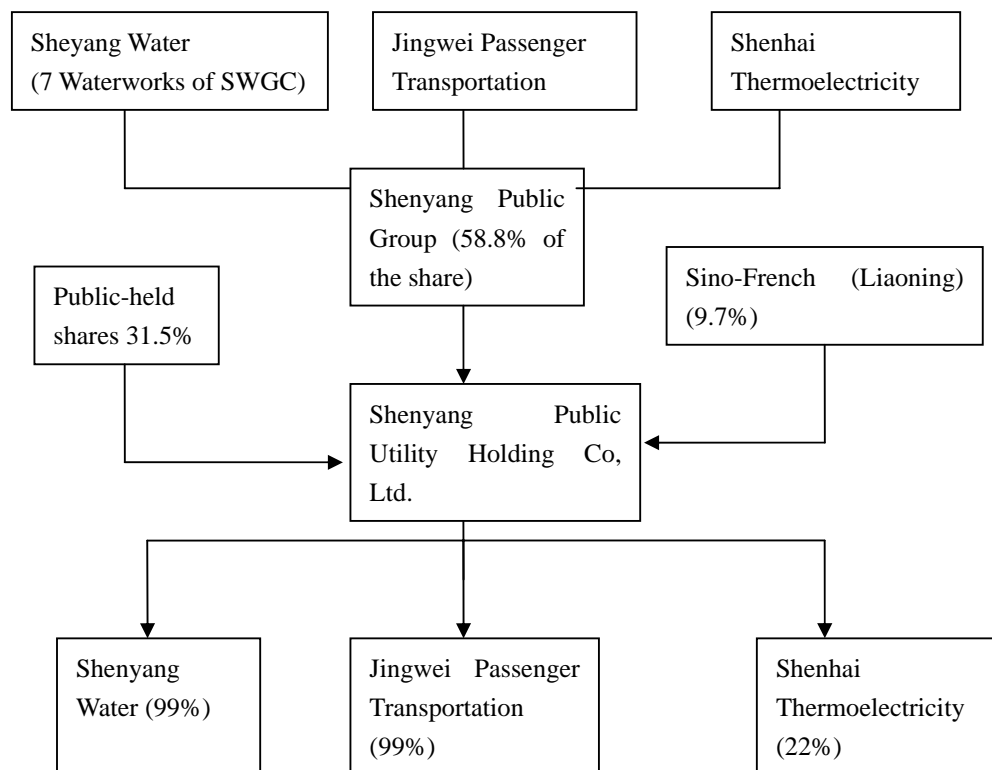
Stage 3: Getting Listed through Packaging

The incorporation of No. 8 Waterworks into Shenyang Public greatly improved the company's asset structure and financial performance, which led to its listing in HKSE.

On December 16th, 1999, by means of placing and public offering, the company issued 420,400,000 H shares with a par value of RMB 1/share for international investors. The offering price was set at 1.70 HK dollars per share. The company raised a net capital of RMB 684,255, 617. On December 16, 1999, the company got listed in H-Share of Hong Kong Stock Exchange.

Getting listed not only changed the property structure of the company, but also raised a large amount of capital. After the issuance, the initiator, Shenyang Public Group (Group) Co., Ltd. still maintained the holding share of 58.8%, Sino-French Water Investment (Liaoning) Co., Ltd. held 9.7% of the share, and the remaining 31.5% were held by the public.

Thus, Shenyang Public Utility Holding Co., Ltd. possessed 99% shares of Shenyang Water, 22% shares of Shenhai Thermoelectricity and 99% shares of the Jingwei Passenger Transportation.



After getting listed, Shenyang Public operated its businesses in the following three key fields: (1) through 7 waterworks of SWGC, produces and sells purified water to SWGC according to the contracted price and sales quantity; (2) through Jingwei Passenger Transportation, provides long-distance passenger transportation service; (3) through Shenhai Thermoelectricity, runs coal fuel and thermoelectricity associated

business.

Although Shenyang Public got listed successfully and pooled a large amount of funds, trouble and burden arising from the listing also started to emerge before Shenyang government.

To facilitate the listing of Shenyang Public and beautify and maintain its performance, SWGC, according to the instructions of the government, signed *Purified Water Supply Agreement* with Shenyang Public, in which, SWGC promised to buy certain quantity of water from Shenyang Public at a fixed price. According to the agreement, the price was fixed at RMB 1.14/m³ and the quantity was set at 1.5 million m³/day, and, even the actual quantity dealt by SWGC was less than the set quantity (1.5 million m³/day), SWGC still had to pay for the purified water according to the set quantity. This agreement ensured the profitability of Shenyang Public, but also laid a heavy burden on SWGC.

Firstly, the city's demand for water showed a momentum of decreasing and only part of the set quantity of water could be consumed. In recent years, due to the adjustment in industrial mix, the popularization of water-saving practice and the increase in water price, actual demand for water in Shenyang city has been decreasing on a yearly basis. At present, only around 1.3 million m³ of water is needed, less than 1.5 million m³/day as regulated in the contract. However, SWGC still has to pay the amount according to the contract, which means it has to subsidize the fees for 200,000 m³ water each day.

Secondly, Shenyang was actually subsidizing the listed company by paying extremely high water price. The price for water sold by Shenyang Public is RMB 1.14, plus RMB 0.54 of network cost for transporting and business inspection, etc., so the actual cost reaches RMB 1.68. However, according to government regulations, the water price for end users should be RMB 1.42. That is to say, for each cubic meter of water it bought from Shenyang Public, SWGC suffered a loss of RMB 0.26.

Due to the above reasons, the listing of Shenyang Public not only failed to bring too many benefits for itself, but also turned SWGC from profit making to suffering from great loss, which led to SWGC's inability to pay water fees to Shenyang Public in accordance with their contract.

Stage 4: Delisting through Replacement

The funds raised by Shenyang Public in the stock market were kept in banks without being used for investment; therefore, they didn't bring any interest. Just as in the transfer of No. 8 Waterworks property rights through introduction of foreign investment, the first and foremost purpose for Shenyang government to open up its public utility was to invite immediate funds necessary for the economic development

of Shenyang city. Shenyang government has expected to make Shenyang Public second revenue source for the city and to raise funds by getting the company listed. However, they realized after the listing that the funds of a listed company couldn't be diverted for any other purpose. Therefore, these funds were kept in banks instead of being used for the construction of the city's public utility. What's worse, extremely high water price has laid a heavy burden on SWGC and the local government. Within less than 3 years after its listing, Shenyang Public came up with a collectable payment of as much as over RMB 300 million, which meant that SWGC was incapable of honoring their payment obligations as regulated in *Purified Water Supply Agreement*. Getting listed not only failed to break through the fund bottleneck in infrastructure construction, but also increased the financial burden of Shenyang government and dragged SWGC away from its development.

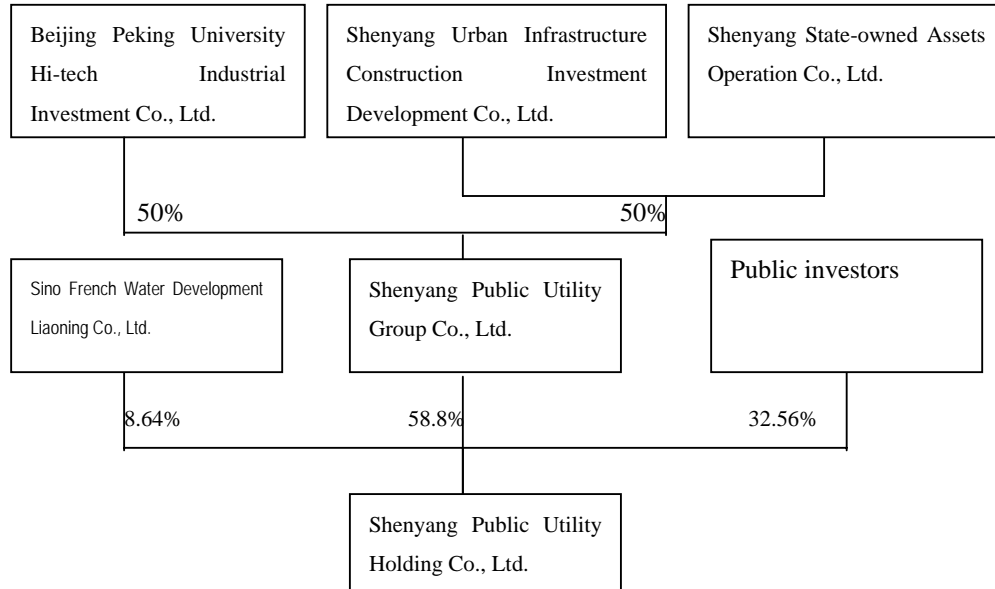
At the same time, due to the rise in cost and maturation of market, the purified water factory project which, according to Prospectus of Shenyang Public, would receive most of the funds raised through the public offering also was aborted, so the company had to face the severe crisis of survival. Due to lack of development space and failure to get back a large amount of collectable payment, Shenyang Public wouldn't be able to survive if no restructuring was carried out.

In such case, Shenyang government had to make another painful decision to replace the 8 Waterworks out of Shenyang Public. Only after the replacement of these waterworks would the government shake off the restrictions of *Purified Water Supply Agreement* so as to free itself from the heavy burden. In June 2002, SWGC repurchased all the 99.37% shares of Shenyang Water held by Shenyang Public with RMB 900 million in cash through the state-owned enterprise-Shenyang Zhengxing Company managed by Shenyang government. Meanwhile, Zhengxing Company transferred the property of waterworks to SWGC.

Replacing the waterworks can free the government from the heavy burden, but it cannot solve the follow-up survival and development problems in the development of Shenyang city, nor can it afford the huge amount of funds needed for the replacement of these waterworks. Therefore, Shenyang government had to introduce new strategic investors to accomplish the assets replacement and to re-group the businesses as well as to provide funds for the replacement. For this purpose, in order to introduce the investment from Beijing Peking University Hi-tech Industrial Investment Co., Ltd., Shenyang government decided to allocate around 3,000 mu of operational land to Shenyang Public free of charge to make up for its loss caused by SWGC's failure to pay the water fees. The land will be used by Shenyang Public for its businesses of educational industry promotion and real estate development.

To enable Sino-French Water, the second largest shareholder of Shenyang Public to agree to the reengineering plan of Shenyang government and the retreating of Shenyang Water from Shenyang Public, SWGC, according to the instructions from the city government, renewed the *Technical and Operation Service Agreement* with

Sino-French Water in 2002. The term of the contract was 10 years, during which Sino-French will continue to provide technical services for the operation of No. 1 to No. 8 Waterworks. Again, in the process of agreement renew, Shenyang side didn't invite any professionals to participate, and the agreement didn't contain any provisions on service quality, qualification of service personnel, etc. After the replacement of the waterworks, SWGC refused to perform this agreement to pay technical service fees to Sino-French Water. The disputes concerning this agreement are still unresolved yet.



Property Structure of Shenyang Public Utility Holding Co., Ltd. after the Replacement of Waterworks

3. Economical Evaluation on This Case

3.1 Economical Evaluation on the Case

3.1.1 Some positive results were achieved in terms of the introduction of foreign investment. (1) The introduction of foreign investment brought immediate liquidity and increased the local government's financial strength. Sino French Water invested to acquire 50% property of No. 8 Waterworks, which brought RMB 125 million cash for Shenyang city. Regarding the huge demands to rapidly expand the urban infrastructure, transferring funds quickly from project A to project B through property transfer is a good way. Although half of the property of the waterworks was transferred to the foreign side, its public facility function of supplying water for the city didn't change. It is just like a BOT project, containing financial innovations. (2) During the following cooperation with Hong Kong Huijin Company, BOT mode was

adopted. Hong Kong Huijin invested USD 25 million to build Shenyang No. 9 Waterworks with a water supply capacity of 100,000 m³ per day. (3) Successful listing of Shenyang Public in Hong Kong raised over RMB 600 million funds. (4) To certain extent, the operational management was improved and advanced management philosophies were introduced. Seen from the operational practice during the 5 years when the foreign side assumed the position of General Manager of No. 8 Waterworks, the management level was actually improved to some extent. The foreign side downsized the 300 employees listed in the payroll to 100; and thanks to scientific calculation, RMB 10 million was saved per year from pesticide fees alone. Therefore, from the perspectives of raising construction funds, reforming property system, improving management level and saving operational management cost, it was right to go in the direction of introducing foreign investment.

3.1.2 In spite of the above effects and gains, seen from the economic rationality of the cost benefits, Shenyang No. 8 Waterworks PPP project is an unsuccessful “political achievement project”. Within just 8 years from 1995 to 2002, the project experienced a U-turn process of “co-investment – repurchase for listing – delisting”. During the first step, the government and relative officials successfully finished their task of inviting foreign investment, however, at the price of over RMB 100 million. In 1995, they attracted RMB 125 million of foreign investment while in 1999 when the foreign side retreated, they repurchased the shares held by the foreign side with RMB 150 million; besides, during the 3 years of the operation, they have paid nearly RMB 70 million to the foreign side in the form of fixed ROI. In addition to that, the foreign side has obtained the 10-year operation service contract for all the 8 waterworks with the excuse that the government had committed breach of contract. It is estimated that this contract will generate a profit of RMB 50 million. This contract is not performed and not submitted to the court due to various reasons. It was also committed that the operational right of the 8 waterworks of Shenyang would be given to the foreign side at a price of RMB 50 million per year as technical service fee. Total sum of the above three items reached nearly RMB 300 million, 2.4 times the sum originally invested by the foreign side. Due to the high price for inviting foreign investment, plus various other reasons, SWGC has suffered a loss of as much as over RMB 200 million by 2002.

During the second stage, the government successfully got the company listed and completed their task of inviting foreign investment; however, this act made SWGC suffer from a debt of RMB 300 million. The government had planned to raise funds by having Shenyang Public listed so as to make it the “second revenue source for Shenyang city”, but it turned out to be a hot potato. The company was dumped into a debt of over RMB 300 million, and finally, it had no other choice, but to get delisted at a price of as much as RMB 900 million, much more than the amount of RMB 680 million it had raised through the initial issuance. Besides, in order to pay off the payable amount, Shenyang government had to allocate 3,000 mu of land free of charge. During the whole process, the government was actually “seeking for

achievements at an extremely high price”.

Although above mentioned series of adventurous trials were carried out in Shenyang in terms of property system reform in water supply industry, none of them was successful. According to insiders from SWGC, in the contract of the construction of No. 9 Waterworks invested by SWGC and Hong Kong Huijin, the ROI ratio was agreed as following: from 2nd to 4th year, it should be 18.50%; from 5th to 14th year, 21%; from 15th to 20th year, 11%. “Hong Kong Huijin has got back all of its investment principal during the first 5 years, so they would just sit and get their profits for the remaining 15 years.” The average water price in Shenyang in 1996 was RMB 1.40 per ton; however, SWGC had to pay RMB 2.50 for 1 ton water it purchased from No. 9 Waterworks that was operated by Hong Kong Huijin, “this is exactly to burden with himself”.

3.1.3 Generally speaking, after some foreign-invested waterworks were established, the Chinese side paid too high a price. The root cause lies in that our water industry is not market-oriented, and it is still strongly characterized by monopolized operation that has been adopted during the planned economy period. The mode of “low water price + loss + financial subsidy” formed during a long period of time in China has led to a practical problem when water enterprises are trying to adopt commercial operation, i.e., how to achieve the balance between investment and satisfactory return. Though a high price was paid, Shenyang still played a demonstration role for the whole country in terms of foreign investment introduction, which was of great importance in breaking the old system and operational mode. Following SWGC’s cooperation with Sino French Water and Hong Kong Huijin, water enterprises in other cities of China also started to introduce foreign investment and this kind of action is still on the increase. Rapid and intense campaigns are also planned in Shenzhen, Beijing and Chengdu, etc.

3.2 Analysis of Economic Activities of Both Parties Concerned in the JV Process

3.2.1 The functions of Shenyang government were seriously misplaced and the government acted beyond its authority to perform the functions of an enterprise. In 1980s and 1990s, China has been always dedicated to the reform of state assets management system, hoping to solve the problem of non-separation between the functions of the government and enterprises in state-owned enterprises through the reform of stockholding system of state-owned enterprises, change of government functions and diversification of properties. However, not until the mid 1990s did China establish the socialist market economy objective which covered three levels including macro-control, market system and modern corporate system. The reform of state assets management system and modern corporate system was still in the trial phase, and there was no clear separation between government and enterprises. The public administrative function and assets owner function of the government were not strictly separated and its state assets management function was far from satisfactory;

besides, there was no dedicated state assets management institute at that time. As for the public utility, it was still in the phase of transforming from public institutions to enterprises. Tap water companies, as being fully owned by the government (bureau-level institutions), were totally and “rationally” managed by the government who directly exercised the duties and rights of assets owners. The standing committee of the government became the “board of directors” and enterprises were excluded from the negotiations. The enterprise was just a chess used by the two sides in their negotiations and all it did was just to sign the agreement.

3.2.2 The government credit was restrained by its debt affordability. There are ultimate differences between government activities and enterprise activities: an enterprise is a legal person organization of assets whose activities are restrained by its own financial strength and who has to carry out cost-benefit analysis; however, a government is a public administrative institution. It need not perform economic verification, it encounters no competition pressure, and it has no concept of bankruptcy; politicians seek for the maximization of rights and they only care about scale and image, so they usually make commitments beyond their own financial strength and fail to honor their own words. For any wrong investment or decision-making, there is no accountability applied to high-level government officials. However, government officials are also restricted by local financial strength as well as all kinds of policies and rules & regulations. Although the government power is not clearly defined, it is not boundless; therefore, if the cost for achieving a certain objective is too high that it is beyond the government’s ability or willingness to mobilize certain resources, the government will choose to commit breach of contract. It can be seen from this case that the establishment of JV Waterworks and getting listed as promoted by the government are both political achievements, but the government status of acting as the contract body is not legal. The government committed breach of contract during both of the phases in this case. During the first phase, the contract was early terminated and repurchase was enforced. During the second phase, the parent company delayed paying Shenyang Water the payable amount, the water fee. The two objectives for these two phases were introduction of foreign investment and getting listed respectively. They were originally methods, but for the government, they became the purposes and the government paid all cost to realize these two purposes, which resulted in the great loss suffered by the SWGC.

3.2.3 Against the backdrop of government administrative monopoly, the eagerness of foreign investment seeking for power-for-rent was not less than that of the local enterprises. Ondeo Water of Suez France established Sino French Water through joint venture with Hong Kong New World Group and started to crack the Chinese market since the 1980s. Sino French Water also adopted the same mode of establishing joint ventures with local enterprises to realize its expansion in China. After two times of co-investment, Sino French Water fulfilled its localization and became very familiar with the rules and regulations of the local government. Under the circumstances that laws and regulations for public utility were not sound yet, there was left a huge space

for its seeking for power-for-rent. Seen from the process of making the contract, its motive of seeking for power-for-rent was quite obvious because Sino French Water, a transnational company who was quite familiar with international business norms, signed such a non-standardized contract without going through any bidding procedures with the Chinese side who didn't have any legal consultant or intermediary agency. Besides, it also requested a high-level fixed ROI rate which was much higher than the international common legal ROI rate. Under the tide of foreign investment introduction, the long-term interest rate at that time was 5-6%, but a fixed ROI of 17-21% was guaranteed in various places. On the one hand, a large amount of domestic cheap capital was idled while on the other hand, they paid a high interest rate to introduce foreign investment. Shortly before the listing in 1999, Shenyang Public suffered a yearly loss of RMB 350 million. The high ROI ratio as requested by the foreign side was based on a water price which would obvious make the Chinese side suffer from losses; in addition to that, the risk return was not reciprocal, either, so were the rights and obligations of both sides. This short-sighted activity that harmed others to benefit oneself, subjectively speaking, was also one of the key reasons that led to the discontinuity of the cooperation between both sides.

3.2.4 The main purpose of the foreign side was to obtain high profits and they invested less into management and technology. Such kind of joint ventures was rather like usury than a real JV. After the 8 Waterworks of Shenyang Water were returned to SWGC, Sino-French Water insisted on the performance of *Technical and Operation Service Agreement* it signed with Shenyang Water to provide operational management services for the 8 waterworks. SWGC agreed with the request of the foreign side who later, only assigned 2 management personnel to participate in the management of the 8 waterworks. SWGC assigned key management personnel and technical professionals, and undertook all the operational management cost, but still, it had to pay RMB 5 million as technical service fee to the foreign side. SWGC thought that it was unfair so it refused to implement the contract and refused to pay technical service fee to the foreign side.

Upon the signature of the contract, Sino French Water sent two technical professionals to Shenyang No. 8 Waterworks, but these two technical professionals were transferred from other joint ventures of Sino French Water in China. In fact, Sino French Water later even attracted several key technical personnel of SWGC and sent them to its other rapidly expanding joint ventures in China.

3.2.5 We think that, after taking back the 8 waterworks, SWGC should set strict and clear requirements for the foreign side during the performance of *Technical and Operation Service Agreement*, including: the content and quality of technical and operation services provided by the foreign side; the quality, performance, heads, working time of the experts and technical professionals assigned by the foreign side; and unqualified personnel assigned by the foreign side being replaced. In case that the foreign side failed to meet the aforesaid requirements, the Chinese side should ask for

compensation from the foreign side or terminate the agreement. Anyway, it is absolutely possible for the Chinese side to restrict the foreign side through reasonable and legal means by making use of the regulations in the contract and agreement so as to protect the benefits of itself to the greatest extent.

But it is a pity that SWGC didn't learn from the lessons that the Chinese side drew from the aforesaid cases of foreign investment introduction and didn't make use of the provisions in *Technical and Operation Service Agreement* in a reasonable and appropriate way; therefore, after taking back the 8 waterworks, it was still under the control of the foreign side in terms of the operation and management rights of the waterworks. Since its financial status was in straitened circumstances, it had no choice but to make the worst one – breach of the contract, to delay paying the amount as regulated in the contract. However, committing breach of the contract will not solve the problem in nature. If legal procedure is introduced, it will be most probably that the Chinese side should not only pay off the arrears but also compensate for the losses suffered by the foreign side due to the delay of payment. What's worse, signing and breaking contracts randomly destroyed the credit of the government and the state-owned enterprises greatly, increasing the investors' sense of moral crisis on the Chinese side and bringing extremely unfavorable influence on the improvement of investment environment and attraction of private capital and foreign investment, which had no good influence upon the public utility ownership system reform and the smooth process of industrialization and marketization.

3.3 Analysis of Root Causes for the Failure

3.3.1 China's laws and regulations on public utility are not sound yet. Because the characteristics of public utility industry have special requirements for the supervision and monitoring of the government, there should be an effective framework for such functions. However, during the transformation of economy, reform of government functions lags behind the market reform and reform of public utility lags behind that of the industrial enterprises; therefore, the line between the government and public utility enterprises has never been clearly defined. Public utility enterprises are embarrassedly positioned as being half-public utility and half-enterprise, and the interference of the government into the operation of public utilities is widely seen. The system environment for public utilities has long been characterized as politics above laws, no laws to abide by and no observance even laws are available.

Among the water cooperation projects guided by the governments, due to the eagerness of introducing foreign investment, almost all contracts included unfair terms such as high fixed ROI ratio, purchase commitment, undertaking of exchange rate risks, etc., which led to the great losses suffered by the Chinese side. The change of government officials and relative personnel resulted in the failure of fulfilling contracted payment; and repurchasing of existing joint ventures at an extremely high cost destroyed the credit of the government. For foreign-invested enterprises, what

they worry about most is the uncertainty. The great changes in policies make foreign investors feel no sense of security.

3.3.2 The unique economic structure and system environment of Shenyang magnified the interference of the Chinese government into enterprises. This should be considered as one of the key reasons that led to the retreat or cautiousness of foreign water companies. This case happened in Shenyang, a city where state-owned economy plays a dominant role, which characterizes more the government's direct interference into the economy. When the development of private economy in some coastal cities stimulates the transfer of local government functions from direct management to indirect management, Shenyang, once the "Northeast King", still found itself entangled in routine management of the state-owned enterprises. The complexity of state stocks reform also slowed down the reform paces of this region, and corresponding ideas, habits, policies as well as systems all maintained the great inertia that came with the state-owned economy. Although the overall pace of reform lagged behind, this didn't prevent the government from seeking sensational effect by taking the lead in some specific reforms for the sake of their own political achievements and image. Water industry has always been the public utility controlled by the country; therefore, SWGC's introduction of foreign investment caused great sensation in China's public utility system. Besides, Shenyang is also the first city to get its public utility listed in overseas stock market. Seen only from the pattern perspective, Shenyang took the leading position in public utility reform across the whole country; however, these activities were not initiated by enterprises themselves; instead, they were maneuvered by the government. The result could only be wrapping old stuff with new package.

According to North's theory of institutional change (1990), the institutional change is a progressive and balanced process, and the reform of one single institution won't happen without the overall institutional environment. The integrated institution is characterized by regulatory structure covering a full range from ideology to customs, and it can't be changed overnight. During the mid 90s, the overall political economy system in Shenyang was still deeply rooted in a mode featuring direct management of state-own economy, and invitation of foreign investment was not initiated by enterprises but more obviously by the government; therefore, it was not hard to understand that what should have been carried out by enterprises have been distorted into political achievement projects. In fact, during the same period, private economy was growing rapidly in coastal provinces and cities like Guangdong and Zhejiang, the economical function of government was changing from direct management to indirect guidance, and invitation of foreign investment was becoming the enterprises' independent actions. Comparatively speaking, the equity transfer system in water industry initiated by Shenyang bodes little meanings of innovation; on the contrary, other cities such as Shenzhen, Shanghai and Beijing are all advancing in front of Shenyang in terms of institutional innovations in the water markets.

3.3.3 Non-reciprocal contracts pose as another direct reason for the ending of the cooperation between both sides. Before 1997, almost all the JV waterworks in China invested by foreign capital adopted the “fixed ROI” mode. In 1997, after realizing that this ROI mode was not reasonable, the Chinese government prohibited its practice. But in fact, most JV water companies still adopted “fixed ROI”. However, according to the policies and rules on this aspect at that time, foreign investment could only be guided into the construction of factories but not the city water supply network, and there were no clearly-defined opening up policies on water price, which, subjectively speaking, made it necessary for foreign investors to fix the sales quantity and sales price of the water to reduce the investment risks as well as to guarantee their own ROI. At that time, we almost agreed to all requirements proposed by foreign investors because the foreign investment was the only thing we wanted, which led to the result that almost all the contracts were not reciprocal. During the JV and listing negotiations, the foreign investors wanted not only equity and holding shares, but also a fixed ROI, which was actually quite rare in international practice. The objectives of the foreign side couldn’t be achieved, either. The result was that both sides were harmed. The JV mode of fixed ROI transplanted the risks to the Chinese side, resulting in a non-reciprocal risk return. Seen from the governance structure of the joint venture, both the foreign side and the Chinese side obtained the controlling right for the operation. With this kind of joint venture, both sides should share the risks as well as share the gains by reducing the cost through the improvement of operational management. However, the reality was to guarantee the foreign side’s benefit at a price of the Chinese side’s suffering from loss. Fixed return applies only to creditor’s rights, and the holding share should not be awarded at the same time. However, the “joint venture” characterized by fixed ROI made us unable to judge whether the foreign side got the equity or creditor’s rights, but actually, the foreign side obtained both of them. Since the benefits of one side are based on that of the other side, this practice of pumping out water to fish will surely not last long.

3.4 Impact of Legal Disputes on Institutional Evolution

3.4.1 Foreign-invested water companies as a whole were entangled in lawsuits in China. Both sides were paying their price for their illegal and non-standardized contract activities. Obviously, the unfair contract was not in favor of the Chinese side. Shenyang government not only paid a high tuition during the process of establishing JV and getting listed, but also had its credit and image destroyed due to numerous breaches of contract. The power-for-rental activity of the foreign side brought them abundant profits within a short period of time, but when local governments were retreating one after another, they found that the market that they have been working on so hard could possibly disappear. Since there were non-standardized practices in both sides’ activities, the contracted benefits could be hardly guaranteed through lawsuits; therefore, the sudden huge profits as regulated in the contract could not be actually guaranteed.

Following the issuance of notice on forbidding BOT projects with fixed return in September 2002 by the State Council, the contracts signed with foreign investors in some places were terminated. Following describes a lawsuit in Changchun filed by Hong Kong Huijin (a water investment company of Hong Kong whose shareholder is Yihe followed by Times).

At the end of February 2004, the administrative litigation of Changchun Huijin Beijiao Waste Water Disposal Factory (hereafter called “Changchun Huijin”) entered its second trial proceeding. The plaintiff in this litigation was Changchun Huijin and the defendant was Changchun government. On March 8th 2000, Changchun Drainage Company signed *Cooperative Enterprise Contract* with Changchun Huijin. Both sides agreed to invest to establish and operate a Sino-foreign cooperative enterprise called Changchun Huijin Waste Water Disposal Co., Ltd., which would last for 20 years. On July 14 of the same year, Changchun government promulgated *Measures on the Management of Waste Water Operation in Huijin of Changchun*. At the end of 2000, this project was running smoothly after being put into operation. However in 2003, when trying to collect the disposal fees, Changchun Huijin found out that Changchun government had cancelled the *Measures* on February 28, 2003. Huijin thought that canceling the *Measures* equaled to destroying the basis of the setup and operation of Changchun Huijin, which impacted the regular operational rights and benefits of the enterprise, so they filed this administrative litigation. However, Changchun government claimed: “The *Cooperative Operation Contract* signed between Huijin Company and City Drainage Company is not based on equality of rights and obligations, it is against the principles of sharing risks and benefits, and there are a lot of items providing guarantees and fixed return; therefore, it is a project with disguised fixed return that is designed to evade China’s laws. However, *Measures*, as strongly requested by both sides, provides support for this kind of fixed-ROI projects that are contradictory to laws.”

It is learned that the projects of this company in Liaoning are undergoing overall re-grouping, repurchase and lawsuits. In fact, the foreign side is also the victim. They have been entangled in the long-term lawsuits. Being eager for quick success and instant benefit resulted in the failure of obtaining long-term benefits. Without a win-win situation, both sides will be harmed.

Sino French Water, the first one entering the Chinese market, also encountered a lot of disputes. In Cangtu of Liaoning, a township city, the government had to provide RMB 7 million financial subsidy per year, which was absolutely beyond its capability. During the three years of Xinmin joint venture project, the Chinese side shouldered a debt of RMB 50 million. The capacity of the water factory there was only 50,000 tons. This project has already been stopped. The following report on Sino French Water’s trouble in Lianjiang vividly reflected the embarrassment of both sides in their disputes:

Review Group of *Lianjiang Sino French Water Supply Co., Ltd. Cooperative Operation Contract* set up by Lianjiang city started their review on July 2, 1997 on *Lianjiang Sino French Water Supply Co., Ltd. Cooperative Operation Contract* signed between Sino French Water and Lianjiang Tap Water Company, and made an analysis report on September 28, 2000 which was reported to the city committee and people's government of Lianjiang. It is pointed out in the report: by making use of the weaknesses of the Chinese side and through government public relations, the foreign side intentionally evades relative laws and administrative rules; this contract is an illegal contract, characterized by explicit unfairness and unfeasibility; if it is to be implemented, it will cause great loss to the Tap Water Company and the city's financial income.

In order to properly solve the problems of Tangshan Waterworks, Lianjiang government sincerely and enthusiastically invited Sino French Water Supply Co., Ltd. and Sino French Investment Co., Ltd to the negotiation table for over 30 times with the latest one held in August in Guangzhou.

Through negotiations, both sides agreed that the *Contract* was unrealistic and it was hard to be implemented. However, disputes still existed in terms of working out a solution for these problems that both sides could accept. We should not leave a waterworks built up with over RMB 10 million without functioning. We expect quality tap water being provided to millions of households. (*Sino French Water Having Trouble in Lianjiang* published on www.h2o-china.com).

Review group of *Lianjiang Sino French Water Supply Co., Ltd. Cooperative Operation Contract* set up by Lianjiang city started their review on July 2, 1997 on *Lianjiang Sino French Water Supply Co., Ltd. Cooperative Operation Contract* signed between Sino French Water and Lianjiang Tap Water Company, and made an analysis report on September 28, 2000 which was reported to the city committee and people's government of Lianjiang. It is pointed out in the report: by making use of the weaknesses of the Chinese side and through government public relations, the foreign side intentionally evades relative laws and administrative rules; this contract is an illegal contract, characterized by explicit unfairness and unfeasibility; if it is to be implemented, it will cause great losses to the Tap Water Company and the city's financial income.

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waterworks built up with over RMB 10 million without functioning. We expect quality tap water being provided to millions of households. (*Sino French Water Having Trouble in Lianjiang* published on www.h2o-china.com)

3.4.2 Facing more and more breach of contracts, foreign-invested water companies have two choices: One is to file long-term and costly lawsuits against the local governments, and the other one is to quench down the disputes through compromise of both sides and then retreat from the Chinese market. Obviously, retreat from the Chinese market that has great potentials is a kind of strategic failure; however, this short-sighted development mode of catching the fish by draining the pool led to this kind of failure in many foreign-invested water companies. In April 2004, news of foreign investment silently retreating from China's water market was reported in newspapers such as *Economic Information Daily*, *China Securities Journal*, etc. "By now, two of the three world leading water companies who first entered into China namely British Times Water, French Suez Ondeo Water and French Vivendi have disappeared totally from the Chinese market. In 2003, Hong Kong Kwok Tai International Co., Ltd. formally quitted from the Chinese water market on which it has worked hard for 8 years and its backbone employees joined Beijing Capital Co., Ltd. British Anglian Water signed cooperative agreement with Beijing No. 10 Waterworks two years ago, but now the project is on standby. And so is Sino French Water. At present, except for the French Vivendi and the new comer German Berlin Water who are still relatively active, most of the early foreign-invested companies have retreated from the Chinese water market." (*Economic Information Daily*, April 15, 2004)

3.4.3 Unsuccessful cases also provide us with useful experience in institutional changes from the opposite perspective. In fact, the disputes over joint ventures in Shenyang and many other cities of China have triggered the acceleration of legal construction in China. In December 2002, Ministry of Construction issued *Opinions on Accelerating the Marketization of Public Utility Market* and in May 2004, *Measures of Management of Concession Operation* was promulgated. Both of these two files marked a great step forward in the institutional change. And at the same time, the joint venture mode of fixed ROI was terminated. Even before the *Measures of Management of Concession Operation* was issued, cities like Shenzhen and Beijing have already had their own measures on concession operation, and they have been continuously improving detailed items of certain regulations

3.3.4 The modes of China's water market are taking shape. The laws and policies of the Chinese government are uncertain, so it is not clear yet as for what kind of mode will be adopted. If BOT, BOO or other concession operation modes are adopted, how can the equality between domestic capital and foreign investment be guaranteed? How can we set clear legal definition for the operational mode integrating water price, asset pricing, transfer as well as water network and waterworks so as to stabilize the business expectation and create a market order under which domestic capital and foreign investment can compete on the basis of equality? During the past, the opening

up of public utility in China was limited to production and there were various barriers to the pipelines and network. Recently the Ministry of Construction has more clearly expressed its attitude of further opening up public utility market, allowing foreign investors to participate in the pipeline network construction and the sales of water product. Foreign-invested water companies such as Sino-French Water are not satisfied of acting only as investors; what's more, they are willing to give their advantages a full play in the fields of water supply pipeline network construction, operation and management, technology, sales, and so on. They have promoted this integrated operational mode in Zhongshan of Guangdong and Chongqing.

In foreign cities where water supply is privately operated, all the work from water production and water sales to collection of service fees is undertaken by professional water companies. The biggest advantage of this practice is as follows: it not only guarantees that water companies can directly contact the users so as to provide quality services, but also helps water companies to sensitively grasp the market demands so as to apply sales-oriented production and reduce waste of resources. Besides, it also facilitates the return of funds for water companies.

3.4.5 After a round of exploitation in the reform of property rights transfer, more and more insiders realized that sales alone didn't bring the actual reform in the water market. According to experiences both at home and abroad, governments still play a dominant role in the investment in water markets, and the competition in this market is mainly reflected in the competition of concession operation which aims to maximize government investment efficiency. This point of view is clearly reflected in our conversation with Mr. Zhang Guoxiang, General Manager of SWGC. He was assigned this position in 1999 to repurchase No. 8 Waterworks and make preparation for the listing. This entrepreneur is quite experienced in the field of overseas listing. Although he was not involved in the preliminary J/V negotiations of No. 8 Waterworks, obviously, he has rethought the ups and downs during the whole process from sell-out to repurchase, from listing to delisting in a systematic manner.

“Basically, China's water market has undergone two stages and now it is moving from the first stage to the second one. The first stage is characterized by: (1) blind investment and transfer of property rights; (2) explicit feature of speculation; and (3) separation between investment and operational management. During this stage, foreign investors are too eager for quick success and instant benefit while the domestic investors only concern about the investment, without trying to cultivate their own operational modes. Capital Group is developing very fast and it has a big amount of investment; however, since there is only investment and due to the lack of management, the company also encounters predicament in its development. During the past 10 years or so, public utility has brought us series of problems, which were mainly caused by: 1) non-synchronous political system and economic system. There exist conflicts between government objectives and enterprise objectives. The governments don't care about effects, responsibilities or cost. The government

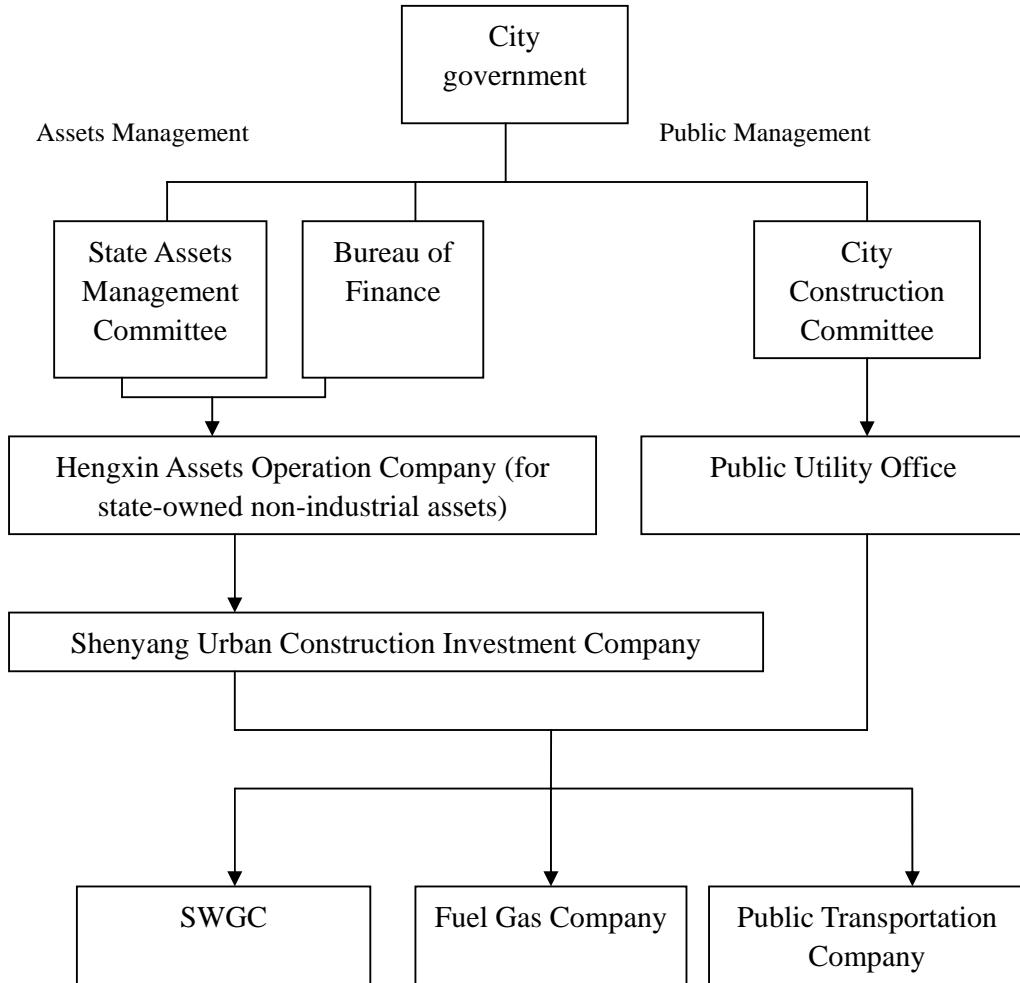
officials are not considerate for their successors. Local finance often runs short. They focus too much on instant benefits, indexes and political achievements. The government officials are not willing to shoulder the burden caused by their predecessors. 2) insufficient separation of executive, legislative and judicial powers. The public administrative function and ownership function of the government are not separated, nor are the ownership and operational rights of the enterprises. The information obtained by the governments and the enterprises are not symmetrical. Enterprises can get information but can not make decisions and there are only responsibilities but no rights for them; governments take part in negotiations on behalf of the enterprises, which is still the common practice in many places in Liaoning province. For example, in places such as Benxi, foreign investors directly contacted Public Utility Bureau of the government without involving Fuel Gas Company and Tap Water Company. 3) lack of rules and policies environment. The water price is not market-oriented so the enterprises can't afford this fee. *Measures on Management of Concession* was not enforced until May 1, 2004.

At present, the water market is ushering into the innovations of the second stage. The main character of this stage is that government acts as the main body of capital in the water market and operational rights go to enterprises which could take the forms of privately owned, foreign invested or joint ventures. The main mode adopted in various countries is characterized as follows: government makes the investment and holds the operational rights. SWGC is trying to become a "water management company" with most of its funds from the private sectors and take part in the biddings for concession operation in various cities. It aims to promote the efficiency in the public utility field through the improvement of management. Huijin Company is considering handing over all its affiliated companies in China to us for management. Some of the foreign water companies are investment companies and some have their own operational modes, but which are not suitable for China. On the other hand, Chinese water companies enjoy absolute advantages in terms of localization. As service enterprises, water companies should set services, especially localized services, as their core competitiveness and try to understand the demands of the local clients.

"At present, selling alone won't solve the problems in the state public utility such as water industry. Instead, competition of operational rights should become the focus and market-oriented water management should be promoted in China. Feasible institutional reforms include clear definition of the rights and responsibilities of the government, debt liquidation, debt recombination, sell-out, employee stock ownership, internal assets regrouping, socialization of supplementary functions such as engineering companies, highlighting water industry, etc. The key issue in the future operation and competition lies in the handling of three relations: 1) localization; 2) relation with investors-concession operation-market environment standardization; 3) integration of the benefits of the investment body, the operating body and the clients."

3.4.6 The system adopted by Shenyang government in its public utility management is

also changing. The public administrative function and state assets management function of the government are starting to get separated and corresponding institutional structure has taken shape. Its management of enterprises is changing from direct administrative management to indirect macro supervision. See the chart below.



Management Mechanism of Shenyang Public Utility

3.5 Conclusion: Significance of the Case and Trend of China's Water Market

3.5.1 Ending: Rules and regulations as well as the legal environment of China's water market will be greatly improved if China's governments, entrepreneurs and foreign investors can learn from these unsuccessful cases so as to continuously perfect the water market business mode characterized by concession operation; maybe this is the

most valuable lesson we can learn from cases like Shenyang Waterworks.

We think the most imperative task in China's water market is still the change of government functions from direct administrative management to indirect industry supervision. The core issue still lies in how to strengthen the responsibility restraint upon the government. The roles and responsibilities between the governments and the enterprises are not clearly defined and the accountability system is not sound yet. The key in the reform, in addition to solve the problem of anti-monopoly in infrastructure industry, what's more important is to exploit, based on the clearly-defined market-orientation, the management modes concerning how government should administer the market and how to deal with the relation between governments and enterprises so as to facilitate the transition to the cultivation of market competition system and finally to bring orderly competition. This requires the governments to change their role in the market from "coach" to regulation-maker and "referee".

However, government officials usually act as both the coach and the referee at the same time, and even the player sometimes. State-owned enterprises belong to the government; therefore, government officials often take it for granted that they can maneuver the assets of these enterprises and they often issue decrees to interfere the regular economic activities of the enterprises. This usually turns out to be against the economic principles of market economy, causing great loss suffered by the Chinese side. Since there is no accountability applied to the owner, possessor and manager of state assets and the supervisory system lacks efficiency, it is very hard to punish relative personnel who cause the loss of state assets due to their malpractice. In the case of Shenyang No. 8 Waterworks as well as other similar transactions that resulted in great loss for the state revenue, there is no way to determine who should undertake the responsibilities. Therefore, since they have no strong sense of responsibilities and sense of crisis, the Chinese negotiators usually only care about political achievement effects arising from the total amount of investment, but neglect the project risks and countermeasures research.

3.5.2 According to Mr. Zhang Guoxiang, GM of SWGC, China's water market is moving from the first stage to the second one, but some latest trend still reminds us that at this stage, the legal environment, economic order and business mode of China's water market are still far from mature. In the places where foreign investors retreated, domestic social capitals instantly swarmed up. Blind investments still exist. Following is from a report in *Global Business & Finance*:

The common practice of most companies in the water industry is to enter this industry or a certain area through acquisition of relative assets such as waterworks. However, this practice alone is not enough. Among the entering capitals, there are few that are qualified to operate water business. Under the circumstances that there are no relative game rules, no mature operational management mode or profit mode, it may be considered as blind for the social capitals to swarm into water industry. Since water

business is popular in the capital market, many companies are competing for these projects. If getting a few, they can raise funds by getting listed.

According to other insiders, besides this practice, many water engineering and technical companies also get themselves involved into BOT in order to get projects: they contribute part of the funds and raise the remaining funds from banks or other investment institutes. They are responsible for the engineering construction of the project and don't care about its future operation. In this way, they can get a large amount of project engineering payment.

Under the original system, the tap water companies were running with an extremely low efficiency as well as a low return ratio; the industry, as a whole was suffering from loss or just making a mean profit. The entering of social capitals at present only changed the operational modes and patterns and increased the efficiency to a certain extent. The blind swarming of capitals will bring more potential harms to the development of the water market. The increase of return in water industry depends on reasonable water price on the one hand while on the other hand, depends on sound operational management to reduce costs and the gap between production and sales. In China, the aging of water pipeline networks is a serious problem. In some cities, almost half of the water supplied leaks out before reaching the taps. Rebuilding and building of pipeline networks have brought rich benefits for some material vendors such as casting pipes providers. If water companies want to outshine others and take the leading position, they have to set proper investment purposes, work out clear investment objectives, make complete investment plans as well as to clearly understand and prevent the risks so as to give full play to the character of stable return, the most attractive factor of water investment.

In fact, despite that foreign investors are cautious about their investment or social capitals swarm into this industry, the greater concern in the marketization of China's water industry is still investment institutional reform and concession management mode as well as the formulation of game rules. Seen from relative policies issued recently, "concession operation and integration of waterworks and networks" has become the ultimate direction for the marketization of China's water industry. Shenzhen Water Group is the representative for the "integration of waterworks and network" and "integration of water supply and drainage" in China. In June 2002, based on Tap Water Group, Shenzhen Water Bureau integrated its affiliated waste water plants and drainage pipeline networks, thus realizing the integration of water supply and drainage and forming a large-scale water group with a total asset of RMB 6 billion.

It has to be noted that during the international public bidding on May 22, 2002, French Vivendi Group won the final bid for the 50% equity of Shanghai Pudong Tap Water and 50 years of cooperative operation at an astronomical amount of RMB 2.1 billion, fulfilling the whole-process service by "Foreign Water Company" from

production to network management, and finally, to sales and supply. This is the first case in which a foreign water company participates in the network and sales management in China's water market. It seems to forebode a brand new start for foreign water companies to enter into China's water market.

In April this year, Beijing Municipal Government decided to cancel Beijing Water Utility Bureau and set up Beijing Water Authority to be responsible for water administrative management. All the water administrative management responsibilities assumed by the previous Beijing Water Utility Bureau were transferred to Beijing Water Authority. The responsibilities for water supply, water saving, drainage and waste water treatment as well as the responsibilities of planning for the exploitation, utilization and protection of city underground water that were originally assumed by Beijing Municipal Administration Commission were also transferred to Beijing Water Authority.

Can the Water Authority who enjoys relatively centralized rights work out appropriate "industrial game rules"? How long will the chaos of China's water market last? How much capital will be fully utilized and how much be wasted? What results should be expected as for the cooperation and competition between foreign water companies and domestic water companies? All of these questions are to be answered by those who wish to be a hero. (Reporter: Wang Ling from Global Business & Finance)

3.5.3 Various evidence indicates that China's water market is moving towards a new stage. A new round of competition among government, state-owned water companies, foreign investment and social capital is being unfolded on a new level. We hope that parties concerned could learn from the past and draw lessons from those unsuccessful cases such as Shenyang Waterworks case so as to actually promote the institutional innovations and facilitate the transfer from the old system to a new system, thus gearing China's water market into the track of healthy and sustainable development.

4. Evolution of Laws and Policies for the Privatization of China's Public Utility Before and After Shenyang Case

Like in all reforms, the central government follows the process of "pilot project-expanded pilot projects-standardization by laws" in the privatization of public utility. The evolution of laws and policies for the privatization of China's public utility can be divided into the following phases:

4.1 Phase of pilot project. This phase ran from 1983 to 1995. The central government selected Shaojiao B Electric Power Plant in the open and "reform demonstration city" of Shenzhen as the pilot project. This electric power plant was operated by Hong Kong consortium through BOT mode smoothly. In 1995, the transfer of the electric power plant was started and it was successfully accomplished in 1999.

4.2 Phase of expanded pilot projects. This phase is from 1995 to 1998. In 1995, the State Planning Commission expanded the pilot projects into Guangxi Laibin B Electric Power Plant, Changsha Electric Plant and Chengdu No. 6 Waterworks.

In order to ensure the orderly and standardized operation of these pilot projects, the State Planning Commission, Ministry of Electric Power and Ministry of Transportation jointly promulgated *Notice on Relative Issues Concerning the Approval and Management of Foreign-invested Concession Projects*, and the Ministry of Foreign Trade and Economic Cooperation promulgated *Notice on Relative Issues Concerning Introduction of Foreign Investment through BOT*.

During this phase, the central government focused its work on the following aspects in terms of BOT standardization:

4.2.1 Ensuring the projects are carried out gradually and orderly, and preventing a general rush action. At that time, BOT was still a brand new concept. The governments at various locations were all lacking in relative knowledge and experience; therefore, the central government was concerned that local governments might swarm up for these projects for the purpose of instant benefits and political achievements. In Article 4 of *Notice on Relative Issues Concerning the Approval and Management of Foreign-invested Concession Projects* jointly promulgated by the State Planning Commission, Ministry of Electric Power and Ministry of Transportation, it is clearly regulated that, “to prevent a general rush action, pilot projects should first be carried out to gain experience before this mode is gradually promoted.” Meanwhile, this Notice also sets clear limitation on the range of pilot projects as well as strict approval procedures.

4.2.2 Guaranteeing the state’s benefits and prevent the governments from undertaking all the risks of BOT projects. One of the purposes of introducing foreign investment into infrastructure construction through BOT mode is to transfer the infrastructure construction and operation risks to private investors so as to reduce the costs and risks of the governments. Since the competition of introducing foreign investment in various locations is quite severe, the central government is concerned that local governments might undertake all the project risks for the purpose of achieving short-term benefits. In Article 3 of *Notice on Relative Issues Concerning the Approval and Management of Foreign-invested Concession Projects*, it is clearly regulated that the government should only compensate for the losses suffered by the project companies that are caused by policy adjustment; that foreign currency exchange of the legal income of project companies should be guaranteed; that no commitment on fixed ROI should be made for any project; and that neither domestic financial institutes nor non-financial institutes should provide guarantee for the financing of the projects.

It is also regulated in Article 3 of the *Notice* promulgated by the Ministry of Foreign

Trade and Economic Cooperation that normally government institutions should not provide any form of guarantee or commitment (such as guarantee for foreign currency exchange, guarantee for loans, etc.) for any project. But in fact, this policy set by the central government was not strictly carried out by local governments in terms of the concession operation of public utility.

In 1994, Shanghai municipal government issued *Measures on Management of Concession Operation of Shanghai Yan'an East Road Tunnel* specifically for the rebuilding of Shanghai Yan'an East Road Tunnel. It is regulated in Article 10 that "Shanghai municipal government agrees with Tunnel Development Company in terms of the regulations of profit distribution, and Hong Kong investors will be rewarded with a ROI rate of 15% from the Tunnel Development Company during the concession period." In 1996, Shanghai Municipal Government again adopted this practice of fixed ROI for the concession operation project of Shanghai Dachang Waterworks. On January 10th, 1996, Shanghai Municipal Government issued *Measures on Management of Concession Operation of Shanghai Dachang Waterworks*. It is regulated in Article 6 of this *Measures* that, "The return on investment and net value of loan repayment obtained by the British investors and the concession company from Shanghai Dachang Waterworks in line with the proportions and calculation method as regulated in the concession contract can be converted into foreign currencies and remitted to overseas by the concession company." It is also regulated that "Shanghai Urban Construction Investment Development General Corporation will provide irrevocable payment guarantee for the regulations that British investors and the concession operation company can obtain return on investment and net value of loan repayment from Shanghai Dachang Waterworks in line with Item 1 of this Article."¹ Dachang Waterworks was officially put into operation in 1998, supplying water for the northwest regions of Shanghai such as Baoshan District. According to the BOT agreement, British Times Water will perform the operation for 20 years until 2018, and as reward, Shanghai water institute will provide construction compensation on a yearly basis and guarantee the fixed yearly ROI ratio of 15%.

In fact, fixed ROI was the common practice for BOT projects during this phase. At that time, in water industry alone, there were over 20 projects with fixed ROI in China, mainly distributed in Heilongjiang, Liaoning, Hebei, Tianjin, Guangdong, Jiangxi, Zhejiang, etc. Therefore, it was not surprising at all that in Shenyang No. 8 Waterworks project, the Chinese side made commitment on providing fixed ROI.

¹ The return on investment and net value of loan repayment obtained by the British investors and the franchise company from Shanghai Dachang Waterworks in line with the proportions and calculation method as regulated in the franchise contract can be converted into foreign currencies and remitted to overseas by the franchise company. Shanghai Municipal People's Government shall support the actual requirements of the franchise company for foreign currencies and apply for the rights of preferential and timely foreign currency exchange to the state foreign currency administration authority. Shanghai Urban Construction Investment Development General Corporation will provide irrevocable payment guarantee for the regulations that British investors and the franchise operation company can obtain return on investment and net value of loan repayment from Shanghai Dachang Waterworks in line with Item 1 of this Article.

In this phase, fixed ROI, usually at a high ratio, could be seen in almost all BOT project.

4.3 Year 1998 – 2002, Cancellation and Regulation of Fixed ROI

Local governments carried out a general rush action without upholding the policies issued by the central government in terms of the reform and opening up of public utility. Almost all of them made commitments on providing fixed ROI for foreign investors, which raised great concern of the central government. Starting from 1998, the State Council has started to cancel and regulate the fixed ROI in BOT projects. In September 1998, the State Council promulgated *Notice on Strengthening the Management and Inspection of Foreign Currencies and Foreign Debts* (Guo Fa [1998] No. 31), requesting the local governments to inspect and prohibit the commitments on fixed ROI in BOT projects.

In April 2001, the State Council promulgated *Notice on Further Strengthening and Improving Management of Foreign Currency Revenue and Expenditure* (Guo Fa [2001] No. 10), reiterating the prohibition of providing guarantee for fixed ROI and project financing in BOT projects and requesting comprehensive inspection so as to prevent the drain of state foreign exchange reserve.

On September 10th, 2002, in order to thoroughly solve the problem of fixed ROI in BOT projects, the General Office of the State Council promulgated *Notice on Relative Issues Concerning Properly Dealing with Existing Projects with Fixed ROI for the Foreign Investors*. It is clearly pointed out in this *Notice* that, “Providing fixed ROI guarantee for foreign investors is not in line with the principle that the Chinese and foreign investors should share benefits as well as risks, and it is against the regulations in relative laws and rules on Sino-foreign joint venture and Sino-foreign cooperative operation. With the current favorable conditions of abundant funds, low financing cost and good overall situation in foreign investment introduction in China, local governments at all levels should make effective measures to properly deal with existing projects with fixed ROI.” As for specific measures, firstly, in terms of those projects in which fixed ROI is paid by the income from the operation of the projects themselves, the Chinese and foreign sides should revise their agreement or contract on the basis of sufficient consultations so as to replace fixed ROI with other legal benefit distribution modes such as obtaining return on investment in advance; secondly, in terms of those projects suffering from loss or running with a mean profit, or those projects in which part or most of the ROI is paid by funds from outside the projects themselves, or those projects in which the ROI is not paid to the foreign side as originally promised, the measures of “revising”, “repurchase”, “transfer” or “cancellation” can be applied according to specific conditions of each project.

Under such circumstances, Shanghai government terminated the concession operation of Dachang Waterworks in July 2003 after negotiations with the foreign investors and

regained from them the property rights of this waterworks. In another case, Changchun government itself cancelled its commitment on providing fixed ROI for Hong Kong Huijin Company.

4.4 Year 2000 -- 2004, Overall Opening up of Privatization of Public Utility

The overall opening up is mainly reflected in the following aspects:

4.4.1 The whole public utility industry is open to private investors including foreign investment as well as domestic private capital;

4.4.2 Newly built projects are open now. Besides, the governments will reform the investment and financing systems, encouraging the participation of private capital into the reform of the state-owned public utility.

4.4.3 Both the central and local governments have issued special rules and policies, guiding, encouraging and regulating the overall privatization of public utility.

4.4.3.1 At the level the central government, it has issued a series of policies to promote the privatization of public utility, and privatization has been adopted in almost the whole public utility industry.

At the end of 20th century, the central government inspected and rectified those abnormal practices in BOT projects; at the same time, it issued a series of rules and regulations to promote and standardize the privatization of public utility in an all-around way.

In 2000, the Ministry of Construction issued *Provisional Regulations on the Utilization of Foreign Investment in Public Utility*, expanding public utilities that were open to foreign investment to all the fields of public utility including water supply, heat supply, gas supply, public transportation, drainage, waste water treatment, roads and bridges, city environment and sanitation, training handling and landscape greenery, etc.

On December 11, 2001, the State Planning Commission promulgated *Opinions on the Promotion and Introduction of Private Investment*. It is regulated in Article 2 of the *Opinions* that, "The fields for investment should be expanded gradually. Unless specially regulated by the state, any field that encourages and allows foreign investment should encourage and allow the entering of private investment; in the fields where preferential policies are issued, these preferential policies should also be applied to private investment; private investment should be encouraged and guided to participate in the construction of operational infrastructure and public utility projects by means of wholly-invested, cooperation, cooperative operation, joint stocks and concession operation, etc. Recently, active efforts should be made to create conditions

so as to establish reasonable price and taxation system for public products as soon as possible. Under the macro-adjustment of the government, private investment should be encouraged and guided to participate in the construction of city infrastructure such as water supply, waste water and rubbish treatment, roads, bridges, etc. Qualified private investment should be encouraged to invest in overseas.” It is made clear that public utility will be open to domestic private capital, and domestic private investors will be encouraged to take part in the privatization process of public utility.

On September 10, 2002, the State Planning Commission, the Ministry of Construction and the State Environmental Protection Administration jointly promulgated *Opinions on the Promotion of Industrialization of City Waste Water and Rubbish Treatment*. It is regulated in Article 3 of the *Opinions* that, “the practice of market orientation and policy support should be upheld. The industrialization of waste water and rubbish treatment should be accelerated.” It is also regulated that, “As for city waste water and rubbish treatment projects invested by social capital, local governments or their entrusted institutes can set ROI reference criterion according to the long-term bank loan interest rate of the same period, and set reasonable waste water and rubbish treatment price according to the project operational cost calculated based on the specific conditions. This price can be used as the upper limit in the biddings. The most optimized plans and the enterprises for project investment and operation should be selected through biddings. The waste water and rubbish treatment fees collected by the government or its agencies should be paid to the enterprises that win the biddings for investment and operation qualification according to the contracts. The agreement signed between the government or its agencies and investors should reflect the principle of “sharing of benefits and risks”, and no guarantee for non-risk ROI should be provided for the investors.”

4.4.3.2 At the level of local governments, they have also issued rules and regulations to promote the privatization of public utility in an all-around way. Shenzhen government and Beijing government successively promulgated in 2003 the rules of concession operation of public utility (infrastructure) to promote and standardize the privatization of public utility. On March 20, 2003, Shenzhen government promulgated *Measures on Concession Operation of Public Utility in Shenzhen*, and on August 28, 2003, Beijing government promulgated *Measures on Concession Operation of Infrastructure in Beijing*.

Apart from that, many provinces and cities have issued relative policies to promote the privatization of public utility in an all-around way. (Details see below table.)

Issued by	Rules and Polices	Date of Issuance	Contents	Comments
Shenzhen Municipal	Plan for Institutional	May 8, 2003	4. Develop BOT or TOT pilot projects of waste water plants. Pingdi Sewage Disposal Plant, Henggang	Shenzhen

People's Government	Reform in Investment and Financing of Shenzhen City in 2003		<p>Sewage Disposal Plant and Gushu Sewage Disposal Plant will be set as pilot projects to attract social capital through BOT or TOT mode so as to exploit and create financing and operational modes for the city's sewage plants already built or to be built. This work will be led by the district governments of Longgang and Bao'an and supported by the city's Environment Protection Bureau, Planning and Land Resource Bureau and Urban Management Office. Preliminary work for this project should be finished before the end of September.</p> <p>5. Establish Rubbish Treatment Plant projects with loans from foreign governments. Longgang Pinghu Rubbish Treatment Plant, Center City Rubbish Treatment Plant Phase II will be set as pilot projects and the plan of using loans from foreign governments for these two projects should be submitted to the State Planning Commission as soon as possible. Meanwhile, active efforts should be made to research the project financing through BOT and TOT modes. These projects are hosted by Longgang district government and supported by City Development Planning Bureau and City Administration Office. The preliminary work for these projects should be finished by the end of December.</p>	Government [2003] No. 84
	Measures on Concession Operation of Public Utility in Shenzhen	March 21, 2003	It specifies the awarding of public utility concession, rights and obligations of the companies that are awarded the concession, government supervision and legal responsibilities, etc.	Shenzhen Government No. 124 as enacted on May 1, 2003
Beijing Municipal People's Government	Measures on Franchise Operation of Infrastructure in Beijing	August 28, 2003	Franchise operation, awarding of franchise, rights and obligations of franchise, pricing, supervision, etc.	Decree No. 134 of the city government, October 1, 2003
Beijing Development and Reform Commission	Opinions on the Implementation of Further Institutional Reform in Investment	Nov. 2003	Provide guiding policies on the implementation of <i>Measures on Franchise Operation of Infrastructure in Beijing</i> , infrastructure construction, opening up of operation market and market-oriented operational methods of specific project.	

	and Financing of Infrastructure of Beijing			
Shangdong Provincial Government	Opinions on the Acceleration of Reform in Public Utility Issued by Shandong Provincial Government	August 15, 2003	<p>Facilitate market-oriented management system and establish standard and scientific government supervision system; break the monopoly, thoroughly open up the investment and financing market, operational market and work market of public utility, allow all kinds of economic organizations and individuals to participate in the investment and operation of public utility, and establish market-oriented operational system; accelerate the corporatization and enterprise institutional innovations, and establish dynamic enterprise operational system. Production and operational enterprises and institutes should finish their corporatization within 1 year, management and work enterprises and institutes should finish their corporatization within 2 years, and efforts should be made to establish a unified, open and orderly public utility market system.</p> <p>Open investment and financing market. Encourage social funds and foreign capital to invest in public utility and realize the diversification of investment bodies by means of whole-ownership, joint venture, cooperation, BOT, etc. Encourage the transfer of all or part of the state stock assets of public utility enterprises through TOT mode. Through biddings and auctions, operate intangible assets of public facilities such as operational right, exclusive operational right, name right, advertising right, fee-collection right, lease right, etc. Carry out infrastructure construction by actively making use of loans from financial institutes both at home and abroad. Encourage and support public utility enterprises to raise funds by getting listed or issuing enterprise bonds.</p> <p>Open the operational market. Franchise operation system will be applied to monopoly industries such as city water supply, gas supply, heat supply, public transportation, rubbish and sewage treatment, etc., and the government should select operation enterprises through public biddings and sign franchise operation contracts. Enterprise with all kinds of ownership both at home and abroad should be allowed to participate in the operation of public utility. Encourage trans-regional and</p>	Lu Zheng Fa [2003] No. 74

			trans-discipline operation of public facilities.	
Ningxia Autonomous Region Government	Opinions on the Acceleration of City Construction Issued by People's Government of Ningxia Hui Autonomous Region	April 18, 2003	3. Actively attract social funds into the construction, operation and management of city infrastructure. Strengthen the market financing of city infrastructure, and by means of service contracting, management contracting, lease, BOT, franchise operation, BOO, stock spin-off (privatization, corporatization), attract all kinds of social funds including private enterprises and individual funds as well as foreign investment into the building, operation and management of city water supply, drainage and sewage treatment, rubbish treatment, roads, centralized heat supply, gas supply and public transportation, etc. The operation rights and ownership of various infrastructures can be sold to qualified private enterprises or foreign-invested enterprises through auctions or consultations. Break the regional, industrial, department and state-owned enterprise monopoly, fully open the markets of city infrastructure planning, design, construction, supervision, operation and management so as to stimulate the competition and improve the construction and operational management level.	Ning Zheng Fa [2003] No.42
Yunnan Government as guided by Ministry of Construction	Opinions on Promoting the Marketization of Public Utility in Cities and Towns of the Province	June 2, 2003	1. Regulate and improve the public utility franchise operation system. Accelerate the compilation of regional laws and regulations on the management of public utility franchise operation. By means of public bidding and signing agreement or other legal methods, clearly authorize public utility enterprises to operate, manage and maintain for a certain period of time and within a certain scope the public facilities such as city water supply, gas supply, waste water and rubbish treatment, sanitation, landscape greenery and public transportation, etc. so as to realize the government macro adjustment of public utility construction and service as well as to promote rational allocation of public resources. 3. Support and encourage all kinds of enterprises in and outside the province and the country to actively participate, by means of wholly-owned, joint venture and cooperation, etc., in the construction and operation of public facilities such as water supply, gas supply, heat supply, public transportation and rubbish and waste water treatment, etc.; Support and encourage all kinds of enterprises with economic strength to make use of their capital, technology and management advantages to	

			participate in trans-regional and trans-discipline reform and regrouping of public utility enterprises through M&A, joint venture, controlling stocks, lease, entrusted operation, stock cooperation, etc.; support and encourage capable public utility enterprises to transform into listed companies or issue enterprise bond, establish city construction investment company or public utility assets operation company with the approval of relative state departments; support and encourage state-owned public utility enterprises to transfer part or all of its current stock assets such as water supply, gas supply, heat supply, rubbish and waste water treatment facilities so as to improve the operational efficiency of stock assets.	
Jiangsu Provincial Government	Opinions on Further Promoting the Reform of Public Utility in Cities of the Province	January 22, 2003	<p>4. Further open up the capital market. Encourage foreign investment and domestic social capital to invest, by means of wholly-owned, joint venture, cooperation, corporatization, BOT, etc., in city public utility so as to realize the diversification of investment bodies and accelerate the construction pace of city public infrastructure; through various means such as TOT, transfer part or all of the state stock assets of the enterprises such as water supply, gas supply, heat supply, waste water treatment and rubbish treatment, etc. so as to improve the operational efficiency of stock assets; sell and lease the operation rights of taxis, exclusive operation rights of buses, name right, advertising right, fee-collecting right of public facilities such as roads, squares, road lamps, bridges and parking lots through rewarding auction so as to fully exploit and make use of the potential resources of public utility; support public utility enterprises to transform into listed companies or to issue enterprise bond; encourage the establishment of city construction investment companies or public utility assets operation companies which will serve as the main platform for the financing in public utility industry, and realize the rolling increment of state assets through comprehensive operation of stock assets.</p> <p>5. Further open up the operational market. In industries that are characterized by natural monopoly such as water supply, gas supply, heat supply, public passenger transportation, waste water treatment and rubbish treatment, etc., franchise operation should be allowed and qualified enterprises should be encouraged to obtain</p>	Su Fu Fa [2003] No. 9

			the franchise operational rights by taking part in public biddings.	
Sichuan Provincial Government	Opinions on the Acceleration of Reform and Development in Public Utility Industry	June 16, 2003	5. Promote franchise operation system. Franchise operation system should be introduced in the industries such as city water supply, gas supply, waste water treatment and rubbish treatment, etc., which means that government will authorize enterprises to operate a certain public utility for a certain period of time and within a certain scope. In the implementation of franchise operation, investors and operators should be selected through public biddings. Investors and operators who win the bid and obtain the franchise operational rights should have their names published in media so as to be supervised by the public; after the publishing period, public utility supervisory departments should on behalf of the government, sign franchise operation contract with the enterprises that are awarded with the franchise right, making clear the rights and obligations between the government and the enterprises and operators who obtain the franchise operational rights. Before building and operating public utility projects within the scope of franchise operation, project building companies should first obtain the franchise operational right, and the building can only be carried out after the signing of contract according to certain regulations. Trans-regional and trans-disciplinary operation of public utility should be allowed. Regarding investment in industries such as city water supply, gas supply, heat supply, public passenger transportation, waste water treatment and rubbish treatment, the term for franchise operation normally should not exceed 30 years; regarding enterprises that undertake the franchise operation in the industries of city water supply, gas supply, heat supply, public passenger transportation and waste water treatment, the franchise operational term should no exceed 8 years; they may take part in the new biddings according to certain regulations. 11. Strengthen the supervision of market. Further regulate the industry management, be strict with market access system, strengthen the quality management of planning enterprises, construction enterprises and landscape greenery enterprises, and regulate the management of franchise operational right in the industries of water supply, gas supply, heat supply, public transportation,	Chuan Fu Fa [2003] No. 18

			<p>waste water and rubbish treatment. The sell and transfer of benefits and rights such as state assets, state stocks and operational right, exclusive operational right, work right, fee-collecting right, lease right, advertising right and name right must be conducted through public biddings or auctions, and they should be reported for approval according to relative regulations so that the state benefits will not be harmed. Current public utility institutes and enterprises should apply for the franchise operation right or work right according to regulated procedures based on the evaluation of state assets, property right registration or regrouping and corporatization, and the government can award the operational right or work right through direct entrustment, then let responsible department sign operation contract with the entrusted enterprises. Standardize financing activities, encourage the introduction of capital through BOT, TOT, etc., but no commitments on fixed ROI should be made. The Provincial Bureau of Construction, together with relative departments, should work out specific measures on the industrialization of public utility industry as well as the franchise operation management and market supervision.</p>	
Office of Liaoning Government as guided by Provincial Planning Commission	Opinions on Promoting the Industrialization of Waste Water and Rubbish Treatment in Cities of the Province	July 2, 2003	<p>For newly built city waste water and rubbish treatment facilities (plants), conditions should be created to facilitate their entering into the market and to adopt competition system, and investors should be selected through biddings. All kinds of domestic and foreign investment bodies should be encouraged to make investment through franchise operation modes such as Building-Operation-Transfer (BOT), or to build and operate city waste water and rubbish treatment facilities (plant) through J/V and cooperation with enterprises that are authorized by the government.</p> <p>For enterprises that invest in the city waste water and rubbish treatment facilities (plant), the project capital should be no less than 20% of the total investment and the operational term should not exceed 30 years. Enterprises that bid for the franchise operation of city waste water and rubbish treatment facilities (plants) should possess corresponding professional experiences and corresponding management and technical</p>	Liao Zheng Fa [2003] No. 48

			professionals. The registered capital should be no less than 50% of the yearly operational cost of the contracted facilities. Generally speaking, the franchise operation term should not exceed 8 years. Upon the expiration of franchise operation term or contracted operation term, new biddings should be held.	
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