

THE IDENTIFICATION OF KEY OBSTACLES THAT HINDER FOREIGN PRIVATE FINANCE INVESTMENTS IN HIGHWAY PROJECTS IN CHINA

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The use of Private Finance Initiative (PFI) as a way for Governments to deliver high quality and cost effective public services is developing rapidly throughout the world. However, there are still many issues and problems that need to be addressed when implementing such projects, which may vary from one economy to another and within various project-types. The Institute of International Finance data suggests that China leads other emerging markets in foreign direct investments or private participation in funding infrastructure projects (over 350 billion US dollars). However, most of the private investment is in the form of Net Equity Investments, but with continuous progress in legal reforms, other forms are increasing rapidly. The research reported in this paper identifies the nature and extent of the obstacles that may hinder the successful implementation of PFI model for highway projects in China. The study has identified critical issues hindering the participation of foreign investors in such PFI schemes at the institutional, transactional and implementation levels. It is anticipated that having identified the issues and risks the research will provide advice and recommendations and develop a specific PFI implementation model that can be used by Government organisations and international practitioners interested in participating in PFI projects in China.

Keywords: PPP, PFI, Risk Management, Highway and China

1. INTRODUCTION

The work reported in this paper is a preliminary study based upon in-depth literature search and unstructured pilot interviews aimed at identifying the issues, problems and obstacles that may affect implementation of PFI schemes for highway projects in China. Similar to the rest of the developing world, China's long-term economic growth requires substantial sustained investment in efficient infrastructure in order to realise the dividends from the opening of markets and the increasing globalisation of the world economy. The World Bank estimates that in the next ten years, developing economies alone will need to invest in basic infrastructure over \$200 billion per year, \$2 trillion by 2005. Over \$1.2 trillion is needed in East Asia alone, which implies about 7% of the region's GDP. China's total infrastructure requirements are estimated at \$500 billion. With these large sums required, the Chinese government has realised that the public sector can not do it all by itself. Therefore, the government has plans for 300 major Private Participation in Infrastructure (PPI) projects worth \$260 billion over the next ten years.

China's highway has been developing very quickly during these years. By the end of 2000, China had developed a highway transportation network of 1.68 million

kilometres. At the end of 2001, the figure had climbed to some 1.7 million kilometres. The Expressway and high capacity roads have reached 25,000 kilometres, rank the second of the world. It is planned that the highway network will reach 1.80 million kilometres, which with 36,000 kilometres of expressway by the end of 2010. (China Tenth Five Years Plan on Transport Development, 2001) With all these volumes of road development, China still has one the lowest kilometre per 1 million inhabitants. Using 2000 figures, China has 940 kilometres per 1 million inhabitants compared to US (25,326 kilometres), Japan (9,096 kilometres) and India (1,784 kilometres). Cobb (2002)

The aim set by the government seems to suggest that they want to duplicate the US interstate highway system (which took 40 years to develop) in no more than 25 years. It is a daunting task having considerably fewer technical and financial resources and economic and poverty levels still within developing countries standard. In such situations, the use of PFI becomes desirable. The initiative brings international private sector skills and finance into projects that use to be wholly or mainly provided by the public sector. PFI projects types range from financially free-standing projects, where the private sector takes on the various risks associated with such projects, to joint ventures between the private and public sectors, where the risks are shared. In theory most infrastructure projects except those being undertaken by the privatised utilities could come within the scope of the PFI, including highways, schools, hospitals and prisons. It suggests that the basic idea of PFI is to transfer the appropriate risk away from the public sector onto the private sector, whilst harnessing what the Government view as superior management skills from the private sector. Consequently the Government gains huge benefits compared with traditional procurement routes, by increasing value for money, better innovation and sufficient savings.

Nickesen, and Mitchel (2000) indicates that already in China, private financing is playing an increasingly important role in the mix of capital for highway construction. Almost all high-grade highways, including new expressways, have toll facilities and are generating significant revenues. Since 1994, the highway sector has attracted private capital exceeding US\$1 billion per year, majority of in Net Equity/Loans, and expected to increase in the coming years. Compared to other developing countries in Asia, Latin America, and Europe, China remains ahead in attracting private capital to highway projects.

2. THE CONCEPT OF PFI

Akelere and Gidado (2003) have indicated that in developing economies, the continuous World Bank funding for services has become inadequate and ineffective. The bank gives funding directly to the government for projects that are over inflated or never get completed, leaving many poorer countries with huge debts because some corrupt officials have not fulfilled the project requirements. Corruption in most developing countries is one of the biggest cancers affecting their sustainable growth. In this type of environment, there seems to be an indication that a blend of private and public funding or partnership may be the solution, since the private sector is driven by demands for return on investment. It is important to note that there is no presumption that the public or the private sector provides the better route for public services delivery. However, experts have suggested that partnerships between the two sectors should be central to any government's aim of establishing first-class public services and infrastructure and promoting economic growth and regeneration. A system is required that makes best use of what both sectors have to offer in the partnerships.

There are a variety of concession and partnership agreements. Some of the most commonly used are Private Finance Initiative (PFI) and Public/Private Partnership (PPP). Franks (1998) indicates that PFI was introduced to the UK in the 1980s. Blackwell (2000) has defined PFI as “the involvement of the private sector more directly in initial asset provision and subsequent operation of the service. The aim is to deliver higher quality more cost-effective public services”. PPP arrangements remain a relatively new phenomenon. Akintoye et al, (2003) suggests that Private Finance Initiative (PFI) is a type of PPP where project financing rests mainly with the private sector. Although it is a type of PPP, there are few clear distinctions between the two and the two terms seem to be taken to mean the same in many projects. Gidado & Smilas (2004) have defined PFI as a contract between a Principal who will grant to a Promoter a right of privilege (a concession) to carry out certain works of construction together with an obligation to operate those works for specified period of time (known as the ‘concession period’). The respective rights and obligations of the Principal and Promoter may be set out and the risks taken by each party clearly allocated. The actions to be taken if certain eventualities occur during the concession period are also specified.

PFI differs from privatisation in that the public sector retains a substantial role in PFI projects, either as the main purchaser of the services provided or as an essential enabler of the project. It differs from contracting out in that the private sector is involved as a provider of the capital asset as well as a provider of services. The initiative focuses on bringing private sector skills and finance into projects that would have previously been wholly or mainly provided by the public sector. The projects could range from financially free-standing projects, where the private sector takes on the various risks associated with such projects, to joint ventures between the private and public sectors, where the risks are shared.

The advantage of the PFI form of procurement is that almost all the risk lies with the private sector and therefore ensures project delivery and compliance to international standards. With this benefit, it may be argued that the PFI method of procurement is the solution to the problems facing governments in trying to be able to provide or fulfil the demand for services and infrastructure, especially in the developing countries. The concept of PFI and PPP can be universal, but the implementation may be dependent upon the social, cultural, financial, political and economic environment.

3. HIGHWAY PROJECTS IN CHINA

3.1 Background

China has spent a great portion of its GDP on infrastructure since 1980s, but it is still far from being adequate. Government investment alone can no longer satisfies the needs for investment in infrastructure. It is apparent that cannot be treated as pure social welfare matter any longer, and therefore market-based approaches must be introduced. This may suggest that in China, PFI is becoming a strategic necessity rather than a policy option. Inadequate funding and inefficient provision, operation and maintenance of infrastructure are the major problems that China’s government faces in this sector. As one of solutions to the problems China central, provincial and local governments have already given up their monopoly in this sector and encourage private involvement, including domestic private and foreign direct investment. From 1990 to 2001, there are 95 PFI road projects with the total cost of \$13,547 million, in which, \$7,341 million are foreign direct investment.

3.2 PFI/PPP Projects

The various levels of government have tried various forms of Public-Private Partnerships (PPP) in a unique model using equity. They have experience in using PPPs in form of non-concession (e.g. subcontracting, licensing and leasing) and concession type projects (e.g. BOT, BOOT). Most infrastructure projects involving private participation are non-concession type projects. These are carried out by joint ventures between a foreign equity investor and a domestic company directly or indirectly owned by the central or local government. In these projects government is not a direct party to the contract and does not directly undertake the domestic company's obligations under the contract (other than providing a "support letter" which is not legally binding). A major disadvantage of non-concession project is the conflict of interest between government's role as regulator and as (indirect) owner of the special purpose vehicle (SPV). Under concession projects, the rights and responsibilities of operating a public service are granted to private company. The government, acting as the granting authority, provides a direct undertaking (or primary obligation) to the SPV, usually through a legally binding, project-specific concession measure. Most of China's concession projects implemented have involved BOT schemes. All of such projects are procured through public competitive bidding. Recently, the provincial and municipal governments are pursuing an alternative to BOT using foreign capital in Hong Kong on highway segments with mature traffic volumes. This is done through issuance of equity shares in Provincial/Municipal Expressway Development Companies (P/MEDC) set up using existing assets pledged or sold to these companies, with a dedicated toll revenue stream already in place for the purpose of generating new income. These revenues can then be leveraged or scrutinised to support share issuance through initial public offerings in the equity markets. This technique is now widely used in China, and in several cases, new financing have been supported by the use of existing, revenue-producing toll facilities partially financed by the World Bank.

Private investors are welcomed to establish joint ventures to develop the highways, which they would finance, in conjunction with an local partner, based on projected revenue. In few instances, private investors have been able to access long-term debt financing for new highway projects in China. The equity markets, and only recently, the domestic financial markets have supplied capital for new construction. The term of debt financing for private firms is limited to 3-5 years, although provincial agencies are able to secure Bank debt for projects with a term of 10-12 years. The more common approach is to issue equity shares through provincial expressway development companies, whose balance sheets are backed by revenue-producing toll facilities.

Most transactions are centred upon initial public offerings for provincial and municipal expressway development companies. These are special purpose entities which function as financing entities for Provincial Departments of Transportation (pDOTs), which then inject operating assets to give the new entities a high level of credit worthiness from the beginning. With revenue-producing facilities in place, the new companies can issue shares for the purpose of repaying the pDOTs, often major shareholders themselves, for the assets. The new listings are generally intended to raise capital for additional expressways and other high-grade highways. There are also certain benefits and advantages for these companies. These include:

1. preferential or non-competitive access to long-term concessions for operation of existing and new highways;

2. rights to the development of future expressways with preferential tax benefits;
3. provisions which restrict competing toll and non-toll facilities; and
4. minimum traffic and revenue guarantees.

Since mid-1996, a total of at least nine equity issues have been completed by mainland expressway development companies in the domestic and offshore markets, with estimated total capital raised in excess of US\$1.6-2.0 billion. This amount does not include significant funding generated in the financial markets by P/MEDC who already own significant toll road assets.

Another way for private investment involvement except BOT is to buy parts of operation right of the completed toll highways and to operate, manage and maintain the highway and share the revenue and profits by rates. The private investors can hold up to 50% of the shares and the transfer period is limited to 20-30 years.

3.3 Opportunities and Challenges for Foreign Investment

The central government of China spent \$106.48 billion on road or bridge construction during the 1990s. However, there has been a major shift in financing from the central government to local governments and loans. In the 1980s, the central government, which had previously provided capital for road construction in the form of grants, switched to loaning the funds, and encouraging the local governments to raise their own capital. The local governments raised so much money on their own that by 1993, foreign capital investment in Chinese transportation exceeded the central government's expenditure which was only 5.7% compared to 33.9% from domestic loans, 3.5% foreign capital and 56.9% from local government capital and other sources. By the end of the 1990s, The World Bank had provided more than \$2 billion in loans for roads, the Asian Development Bank provided approximately \$3.5 billion via its Japan Special Fund.

By 2010, China plans to complete 36,800 km. By 2015, it plans to build four-lane highways connecting all the rural county seats to the national system. To deal with the in-balance between the eastern and the western parts, the government intends to spend more than \$84.5 billion over the next 20 years to build approximately 350,000 km of new roads in western China. In order to achieve this, the government has recognised that private/other sources of funding mechanism need to be put in place. There is drive to encouraging joint ventures between Chinese and foreign enterprises in investing in the construction of highways. Regulations relating to the encouraged sectors were designed to direct foreign-direct investment (FDI) to areas in which China could benefit from foreign assistance or technology, such as in the construction and operation of infrastructure facilities.

Another key driver to opening up the market and attracting foreign investments is the Beijing hosting the 2008 Olympic Games. Specific to this event China has identified 142 projects valued at \$22 billion, and approximately half of these projects are related to surface transportation. All of the contracts are open to foreign bidders, but Chinese companies are expected to receive preference. Foreign companies that can also offer a substantial capital investment in the project, or advanced technology, may receive a more-favourable review.

4. ISSUES AND OBSTACLES FOR CHINA PFI/PPP PROJECTS

China has massive infrastructure investment needs over the next 20 years, indicating great potential for private investment. Although the government is actively seeking new financing methods and has accepted some modes for private participation to meet the special needs of the country and to be attractive to foreign investors and lenders, there are still many problems limiting the private participation. Such problems include:

- unclear government policy on public and private financing,
- lack of transparency in the approval process,
- weak contract enforceability,
- defaults on loans and bonds,
- weaknesses in the policy environment and restrictions on market entry and exit
- problems in the legal environment, including weak implementation of the rule of law;
- lack of financing options
- infrastructure constraints
- human resource constraints
- lack of management know-how
- poor access to reliable information and professional services

Some government policies are bias against private sector market entry and exit such as the hurdles in licensing and registering businesses, listing requirements that favour state-owned enterprises (SOEs), and arbitrary application of fees. Another major obstacle is that the current environment lacks sufficient transparency and an effective competition policy. Local protectionism exists in various forms, making it difficult for many private companies to enter new markets and encourages corruption.

The legal environment also emits constraints such as the ambiguous property rights. Private property rights are not accorded the same treatment as public property rights. Although an adequate legal framework exists in many parts of China, enforcement is not consistent, transparent, or predictable.

Availability of reliable information and professional legal, accounting, and consulting services is limited under the prevailing business environment. Although access to economic, market, and production information has improved in recent years, the quality and reliability of information is still inconsistent.

The issues/obstacles that hinder foreign private investments in China have a wide range of sources and can be classified into the political, socio-cultural, legal, financial, administrative, traditional, and technological categories.

4.1 Financial Issues/Obstacles

Most of the private investment in China's infrastructure has been foreign and has been primarily equity, with little debt financing. In fact, the first and foremost constraint for infrastructure financing has been lack of domestic funds. There are reasons why foreign financing alone cannot and should not undertake infrastructure investments, and a significant portion of project financing has to come from domestic sources. This

is because infrastructure projects are invariably important investment projects in which strategic and political considerations preclude full foreign ownership.

Lu Jie (2003) has shown that there are likewise known issues and concerns involving currency convertibility and repatriation of profit, which have constrained the ability of foreign investors to repay commercial debt.

The financial constraints/obstacles can be summarised as follows:

- Lack of a financial framework
- Lack of liberalised financial institution
- Currency convertibility and repatriation of earnings to investors outside the mainland is a problem
- Inefficiencies of central planning
- Complicated tax incentive system and discrepancies between central, provincial and local government
- Quality of credit risks
- Weak banking and state enterprise sectors

4.2 Political Issues/Obstacles

Political risks are inherent in the Chinese market, from site selection and construction through completion, operations and marketing. This mainly originate from unfledged rule of law, widespread government corruption, financial speculation, misallocation and appropriation of investment funds, as well as ignorant officials and unfair competition and poor management of the projects.

The reason why there are relatively few private sector projects is that governments have not had clear, uniform goals for privatising infrastructure. When they started to get involved with the private sector in infrastructure, governments did not really understand what was required of them. There is no clearly laid out implementation model with clear methods, procedures and policies. Without such guidelines, it will be difficult to attract private FDI, or the investors will demand return guarantees which governments cannot accept.

The key political obstacles can be summarised as follows:

- Unclear government policy on public and private financing
- Legal uncertainty
- Insecurity and human rights issues.
- Conversion and transfer Policies
- Expropriation and compensation
- Investment climate
- Localisation
- Lack of resource base

4.3 Legal Issues/Obstacles

Some of the laws and regulations in China are found to be major obstacles to private sector participation in highway projects. These obstacles may include:

- Absence of a well-structured legal and regulatory framework.
- framework and regulatory structures are considered weak
- Regulatory system lacks transparency
- Lack of a system of property laws and regulations
- Rigid rules of foreign investment
- Complex basic laws on governing foreign direct investment

4.4 Administrative Issues/Obstacles

No different to other emerging economies, China faces similar administrative constraints. These include:

- Limited support from the Government
- Slow registration procedures
- Corruption
- Bureaucracy
- Inappropriate/inexperienced staff taking responsibility
- Poor co-ordination among related departments and sectors
- Short supply of skilled managers
- Wrong partners

4.5 Cultural Issues/Obstacles

The cultural parameters may be complicated, but they are manageable if made very clear and given readily available expert support. Business people in each culture look for different kinds of 'signpost' when considering a possible business opportunity. For example, the none availability of some types of data that are taken for granted in the West may not readily be available in China, simply because the Chinese business person may have a different view as to what is crucial in establishing a business relationship.

In China, it is impossible to do business without the development and maintenance of firm personal relationships. Where available and trustworthy information and enforceable contracts are not the basis of a business culture, personal relationships and trust are the essential bedrock for business dealings.

Language barrier and access to reliable statistics data are key obstacles. It is difficult to obtain reliable and comprehensive third party information and assessment of companies in China, which suits Western business demands for both reliable content and incisive and relevant analysis and assessment. Almost everything for the file and information is in Chinese. Sometimes the translation into English may have misleading idiomatic inaccuracies.

5. CONCLUSION

China is the world's biggest new market with massive opportunities, but any Western business seeking entry into this market faces profound cultural, legal, political, financial and administrative complexities.

Research by World Bank and others has shown that private investment in infrastructure in developing economies is essential. In addition to providing more funding streams, it also promotes better risk allocation, project management, monitoring and overall project accountability. However, in order to facilitate this partnership, it is necessary to firstly identify the obstacles associated with the private finance initiatives within individual economies. This gives a clearer understanding of how project controls are to be applied throughout the project, how to management under-performance issues when they arise, and to review the role of all key stakeholders when the cause of these issues/obstacles arise.

The public-private partnership requires government to give a firm commitment to increasing the role of private sector in infrastructure provision. The Chinese government should continue to provide much of the nation's infrastructure to the local or foreign private sector to manage. In doing so government can provide a foundation on which the private sector can build its own contribution to national development. China may adopt the Design-Build-Finance-Operate (DBFO) model used in the UK, Ireland and South Africa. This is where a private operator generally acquire existing road and is required to perform certain upgrading work or to construct new sections of road and is subsequently permitted to operate the road under a 30-year concession and be paid based upon shadow tolls determined by use and availability. The advantage to such initiatives is that the government is comfortable that the revenue it must pay the private operator based upon shadow tolls will be less than it would have to pay were it to carry out the upgrading work and ongoing maintenance over the 30 year period.

Majority of the obstacles seems to hinge upon a lack of consistent policy and institutional framework. Government needs to provide a clear and stable policy and institutional framework within which there can be efficient allocation of resources across sectors and projects, timely and credible contract awards, and cost-effective services to consumers. System and organization reforms are necessary in order to prevent corruption on administration.

There is a limited experience of management of PFI/PPP contract. The principles are different from other services contracts due to the transfer of risk and the length of the contract. It would be necessary to study the existing contracts and measure the effect of the identified obstacles. Once this is carried out, it will provide a base upon which an effective PFI implementation model can be developed for China. The model will be expected to provide best practice or guidelines for both the Chinese government and local/foreign investor in highway development in China. The fully developed and tested model is the overall aim of this research.

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