

# **Development of Public Private Partnerships (PPPs) in China**

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## **Introduction**

There is no hard and fast definition of public private partnerships. One way that PPPs may be defined is as the partnerships between the public sector and the private sector for the purposes of designing, planning, financing, constructing and/or operating projects which would have been regarded traditionally as being within the remit of the public sector. PPPs take many forms. Examples include private finance initiatives, design-construct-maintain, build-own-operate, build-own-operate-transfer, buy-build-operate, sale-leaseback, etc. The spectrum of possible PPPs extends from businesses almost entirely controlled by the private sector at one end, to those almost entirely controlled by the public sector at the other. PPPs have been increasingly used in many countries as an alternative approach for the procurement of public facilities and services. While PPPs are relatively new in China, there is a great potential for their application due to the strong demand for public facilities and services. This paper is to examine the development of PPPs in China.

## **Development of Private Sector's Participation in Public Facilities**

In the past, China operated under a socialist planned economics system. At that time, all companies were owned by the People's Government and there were no private companies and free markets. Starting from early 1970s, China introduced an open economics policy in some selected cities. Some state-owned enterprises in those cities started their reform by establishing modern company management structures and systems. With the introduction of company laws, stated-owned enterprises were re-structured into limited liability companies which could be owned by local and foreigner investors. As some stated-owned enterprises became private companies, the provision of public facilities and services was no longer monopolized by the government. In the early 1980s, limited market competition existed in some major cities. At that moment, the economics was still dominated by stated-owned enterprises.

Starting from the end 1980s and early 1990s, more cities opened up their markets for public

facilities and services. Many local governments were able to attract wider sources of local and overseas investment for speeding up urban development. There were more and more private companies established during the 1990s. After ten years of “experimental” experience, China built a foundation for privatization of public facilities and services on a larger scale.

Since year 2000, market mechanisms have become mature in most cities. PPPs have also become one of the government’s strategies for the provision of public facilities and services. The government has started to strengthen its monitoring and control systems on public facilities and services provided by the private sector. As the proportion of private companies has increased, there is more and more market competition from both local and foreign investors, all of whom fight for market shares. Nowadays, some large private companies have even started to expand their business into overseas countries.

### **Causes of Reform on Provisions of Public Services**

There are three major causes why the China government needs to reform the provision of public facilities and services. The first cause is due to an inadequate investment in public facilities and services. China is undergoing a high rate of urbanization. Since 1989, the urbanization rate has grown at 1.4% per annum. Each year, there has been an influx of 20 million villagers into cities, naturally creating an ever increasing demand for urban facilities and services. At the end of 2003, the urbanization rate in China was only around 40%. Based on international experience, if the urbanization rate is between 30% and 70%, it is considered as a period of high demand for basic public infrastructure and services.

On the other hand, the standard of current public facilities and services is relatively low. Thus, substantial improvement is required to meet practical needs. For instance, only 86% and 42% of cities have water supply and sewage treatment respectively. The road area coverage ratio is only 8.6% which is fairly low compared with the international norm of not less than 20%. Indeed, expenditure on public facilities and services only accounts for a small portion of the total gross domestic product (GDP). It was 0.8% and 1.7% for 1985 and 1995 respectively. In 2003, it increased to 3.82% with a total expenditure of 446.2 billion Yuan. Therefore, the government is in need of greater capital investment in public facilities and services in order to meet society’s needs.

The second cause is the limited funding sources and inadequate private investment in public facilities and services. So far, the main source of investment in public facilities and services relies heavily on government funding. In 2002, the total investment in public facilities was 315 billion Yuan, 80% of which was from the government and the remaining 20% from the private

sector. The government was the main source of investment. Preserving its roles in enterprises only gave rise to monopoly on provisions of public facilities and services. With the speedy growth in urbanization, reliance on government expenditure is insufficient to make things happen. The government should widen the funding sources, particularly from the private sector.

The third cause is because of the slow rate of reform of state-owned enterprises and their poor provision of public facilities and services. A high proportion of state-owned enterprises, coupled with their obsolete management systems and lack of market competition and social responsibility, all resulted in inefficient use of capital. In 2003, 80% of public transportation companies in 66 cities and 60% of water supply companies in 89 cities were operated at losses. Thus, there is a huge potential for improvement of efficiency in the provision of public facilities and services by the private sector.

### **Problems with implementation of PPPs in China**

Past experience has indicated a number of problems with the implementation of PPPs in China. PPPs are relatively new to government officials, private investors and consumers and there is an apparent lack of experience on the commercial, technical, legal and political aspects of PPPs. Even foreign investors with substantial overseas experience in PPPs may not be able to understand all relevant practices and procedures instantly because China has only opened up its market for a relatively short period of time.

There has been too much emphasis on attracting investment from the private sector and too little attention to market competition. The main objective of PPPs is to make use of market competition in order to ensure the effective use of resources in the provision of public facilities and services. However, some local governments have placed too much emphasis on attracting private investments by offering even more favorable terms than the normal national status.

PPPs have been treated as the privatization of public facilities/services, focusing on short-term return without a spirit of long-term partnership. In order to achieve a high return on investment, both the government and private investor have tried to charge a high fee for the provided facilities and services as well as assigning land use without paying any charges. The financial risk and burden are shifted to the public who face a high price for the public facilities and services without getting the corresponding increase in service quality.

There has been inadequate knowledge on PPPs too. Both the government and private investor have made decisions which were not based on thorough and objective technical and financial

analyses. There was also no proper risk assessment. When problems arise, parties will look for opportunities to escape from responsibility.

There has been a lack of administrative framework for PPP projects. Amongst various government departments, it is not clear which department has the authority to negotiate and sign a contract. It is quite unpredictable whether the promise given by an appointed government representative is enforceable. Thus, some overseas investors may insist on the passing of the relevant rules or regulations for a PPP project to assure that the signed agreement will be enforceable.

In order to attract foreign investment, some local governments have promised more than they are capable of doing. When the relevant government officials change, the new officials may look for ways to terminate those agreements which are found to be unfair or unreasonable.

The price control system is yet not perfect. The public also finds no effective channel to voice its opinion on the PPP projects. If there is a dispute, whether the matter can be resolved under the administrative law and contract law is not clear.

### **Guides and Rules for Promotion of PPPs**

In order to overcome the aforesaid problems, the government has actively promoted some good PPP practices for a better provision of public facilities and services. Since year 2000, the government has introduced a series of policies, guides and rules relating to the provision of public facilities and services by the private sector. The Ministry of Construction issued the “Opinions on Acceleration of Privatization Process of Public Facilities” in December 2002 and the “Rules on Management of Franchised Operation of Public Facilities” in May 2003.

Based on the above Central Government directives, local governments started to establish detailed rules governing the scope, procedures and relevant details for opening up the market for the provision of public facilities and services. For instance, the Shenzhen Government issued the “Rules for the Franchised Operation of Public Facilities” in May 2003, and the Beijing Government issued the “Rules for the Franchised Operation of Basic Urban Facilities” in October 2003.

The above rules lay down important steps as to how policy direction turns into practice for the privatization of public facilities. It touches upon such issues as:

- How to use a franchised operation for the provision of public facilities and services;
- How to deal with the property ownership of newly constructed facilities;

- How to determine the period of franchised operation;
- Whether the franchised operator needs to pay any fees for the right of operation;
- How to deal with the property after expiry of the franchised period;
- How to reform the existing state-owned enterprises in line with the franchised operators, particularly on the relevant service charge/fee;
- How to set a reasonable fee to balance the investor's return on investment;
- How to set up a subsidy mechanism where necessary;
- How the government exercises an effective control on the quality of public facilities and services; so on and so forth

In year 2004, the Ministry of Construction also issued a "Sample Document for the Franchised Operation of Urban Water Supply, Gas Supply and Waste Disposal" for providing more details for the whole franchised arrangement of public facilities. This Document only sets out some principles; both parties have room to negotiate on the detailed contents of the franchise agreement according to the actual circumstances. More recently, the Beijing Government issued the "Regulations for Franchised Operation of Beijing Basic Urban Facilities" on 1 March 2006. This is the first formal regulation providing an exemplary legislative framework on the provision of public facilities by the private sector. Basically, the PPP model adopted in China is based on the traditional build-operate-transfer.

### **Way Forward for a Proper PPPs System**

With the introduction of some guides, rules and regulations, it is expected that many of the aforesaid problems would be overcome. However, there are some ways forward for improving the PPPs system in China. Firstly, the government should generally follow some good international PPP practices. Secondly, the government should thoroughly consider interests of all parties before making a decision on a PPP project. Thirdly, a flexible, independent, transparent, accountable and professional monitoring system, with the appropriate authority, should be built into any PPP project. Finally, a proper judiciary system for dispute resolution is important to protect the private sector's investments in capital intensive PPP projects.

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