JONES DAY

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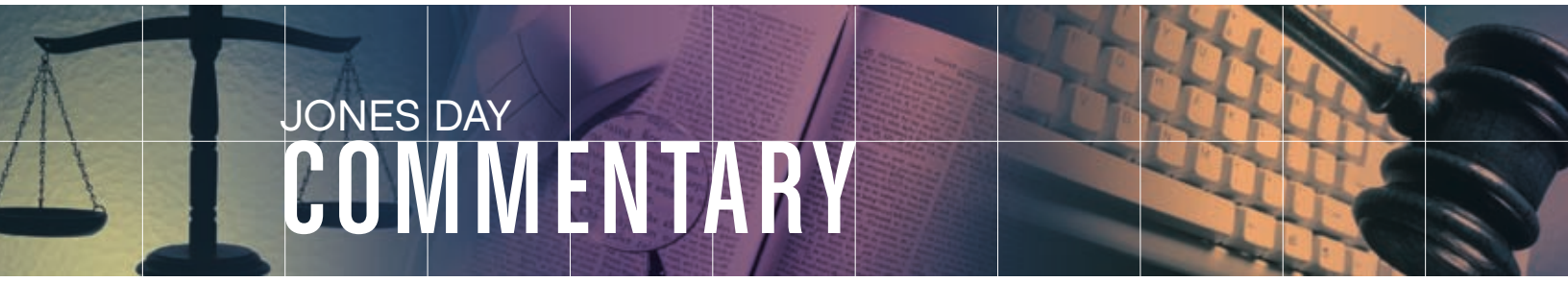

THE IMPACT OF THE WTO ON CHINA'S CONSTRUCTION, ENGINEERING, AND DESIGN INDUSTRIES: FIVE YEARS OF CHANGE AND CHALLENGES FOR FOREIGN COMPANIES

China's construction industry is a mainstay of the Chinese economy, and in recent years it has undergone unprecedented growth. The continuing infrastructure development driven by the 2008 Olympics in Beijing and the 2010 World Expo in Shanghai will continue to play a significant role in raising the quality level of construction activity in China and expanding the use of innovative contractual and financial models to improve standards and efficiency.

Prior to China's accession to the WTO, there were two options available for foreign contractors and designers wishing to perform construction work in China: (1) incorporate a joint-venture entity in China; or (2) register a "project branch" in China on a project-by-project basis under Decree 32 issued by the PRC Ministry of Construction (MOC). Foreign contractors were prohibited from incorporating a wholly owned entity to do construction work. Most foreign contractors opted for project-branch registration (also known as "the registered foreign contractor system") because, among other advantages, this option did not require the injection of paid-up capital into China or full compliance with local qualification requirements. Under Decree 32, it was also possible for foreign contractors to convert RMB earnings into foreign currency and remit the proceeds abroad. A third option existed for foreign designers only, insofar as they could provide limited engineering, design, procurement, and consulting services from offshore.

Although this system was not very convenient, in that foreign contractors and designers had to apply for approval for every project they undertook, it had its advantages. The main advantage was flexibility. Foreign contractors or designers did not need to maintain a significant presence in China unless they had work there. The system was favored by foreign

contractors and designers who came to China because their regular clients in their home countries were moving to China to set up businesses and engaged them to carry out specific projects.

Since China's accession to the WTO, the principle regulatory mechanisms controlling foreign participation in the construction and engineering industry in China have been Decree 113 and Decree 114, jointly issued by the MOC and the Ministry of Commerce (MOFCOM). Decree 113 and Decree 114 were issued in September 2002 and came into effect on December 1, 2002; since then, Decree 113 has been the subject of much clarification. In particular, the MOC issued Implementation Regulations for Decree 113 in April 2003 and repealed Decree 32 as of July 1, 2005. In addition, Decree 113 was further clarified by Circular 159, which was issued by the MOC on September 21, 2004; Circular 159 was itself amplified by a supplement issued by the MOC on January 7, 2005. In essence, Decree 113 and Decree 114 allow the establishment of Foreign-Invested Construction Enterprises (FICEs) and Foreign-Invested Design Enterprises (FIDEs), respectively, in China. While these new regulations have streamlined the approval process, they have also been criticized for limiting market entry for foreign contractors and designers.

SIGNIFICANT DEVELOPMENTS IN THE PAST YEAR

The Chinese construction industry has undergone some significant changes in the past 12 months. Since the promulgation of Decree 113 and Decree 114, the MOC has concentrated almost exclusively on Decree 113 and to this end has issued several circulars and opinions to clarify the implementation of Decree 113. However, very little was said by the MOC about the implementation of Decree 114, and only Implementation Regulations for Hong Kong and Macau companies under the CEPA arrangements between Hong Kong, Macau, and the Mainland were issued on December 9, 2003.

However, during 2006 (most likely because of the impending WTO deadline of December 11, 2006) the MOC was much more active with design issues. Draft Construction Engineering Design Qualification Standards were issued on January 26, 2006, and the Circular on the Administration of Incorporation of Foreign-Invested Construction and Engineering Companies (Circular 76) was issued by the MOC on March 29, 2006.

Circular 76 is helpful because it has the effect of delegating review authority for FICEs and FIDEs to provincial-level construction authorities. This follows MOFCOM's delegation of its own approval authority for such foreign-invested enterprises to provincial-level commerce authorities. In accordance with Circular 76, provincial-level commerce administrations must now obtain the opinion of the same-level construction authority before deciding whether to approve an application to set up a FICE or a FIDE. Previously, provincial-level commerce administrations had to obtain the opinion of either the MOC or provincial-level construction authorities, depending on the qualification certification that the foreign investor was seeking. In effect, the MOC has delegated its approval process to provincial-level construction authorities for Special Class and Class 1 construction qualifications and Class A and Class B design qualifications. The MOFCOM and MOC delegation of approval and review authority considerably simplifies the application procedures for prospective foreign investors and may help speed up the processing of such applications. Now, regardless of the qualification level of the prospective FICE or FIDE, all investors may submit their applications to the provincial-level commerce administrations, which in turn will obtain the opinion of the provincial-level construction authorities before deciding whether to approve the application.

However, the most important development in 2006 was the issue of the draft Decree 114 Implementation Regulations by the MOC on October 10, 2006, which were stated to come into force on December 11, 2006 (coincidentally the deadline for China to effectuate its WTO commitments). Unfortunately, the final Decree 114 Implementation Regulations were not issued until January 5, 2007 (and not published until January 31, 2007). Accordingly, foreign engineering and design companies were not able to submit applications to establish FIDEs until the end of January 2007.

SPECIFIC ISSUES FACING FOREIGN CONSTRUCTION, ENGINEERING, AND DESIGN COMPANIES

Construction Works Sector – Decree 113. Decree 113 sets out the steps that must be taken and the qualifications that must be obtained in order for foreign construction companies to undertake construction activities in China. To undertake construction works in China, a foreign construction company must establish a local presence by setting up some form of Chinese legal entity (either a Wholly Foreign-Owned Enterprise (WFOE) or a Sino-Foreign Joint Venture), and this Chinese legal entity must, after establishment, apply for a construction-grade qualification (either Special Grade, Grade 1, Grade 2, or Grade 3, in particular industry categories). The grade qualification determines the maximum size and scale of project that the construction enterprise may undertake.

Registered-Capital Requirements. The capitalization requirements to obtain qualifications certificates are high (US$38 million for a Special Grade construction qualification (*i.e.*, an unlimited qualification to undertake projects of all types and values)) and in addition, unless they have Special Grade qualifications, contractors cannot undertake projects with a value greater than five times their registered capital. For example, a contractor with registered capital of US$1 million can undertake only those projects valued at less than US$5 million. This prevents international contractors, which have low capitalization because of the specialized nature of their work, from effectively contributing to the market.

These restrictions are onerous for foreign companies, and the "five times registered capital" limitation placed on projects means that foreign construction companies must invest significant registered capital in order to qualify for large-scale infrastructure projects. As an alternative, it has been suggested that the financial strength of parent companies or affiliates should be taken into account and the typical international practice of parent-company guarantees or bonding should be used to partially replace the registered-capital requirement.

Personnel Requirements. Decree 113 mandates that large numbers of personnel are required in order to obtain relevant qualification certificates. For example, for a Class 1 Building Project Main Contractor qualification, the applicant must have 300 technical and managerial personnel. In addition, all foreign technical or managerial personnel must spend at least three months per year in China.

Experience Requirements. Although Circular 159 allows a FICE to employ foreign service providers as long as such foreign service providers possess experience and skill sets equivalent to those required for Chinese technical or managerial personnel, full recognition of foreign qualifications is not yet accorded by the MOC and is generally considered on a reciprocity basis. In addition, under Circular 159, a FICE is no longer obliged to employ a minimum number of local technical staff, such as project managers or engineers.

Track-Record Requirements. Circular 159 also allows the foreign company's international track record to be used as part of its application for an initial FICE qualification. While this is an improvement on the original position under Decree 113 and the Decree 113 Implementation Regulations, it remains restrictive. This is because the MOC will consider the international track record of the investor company only, not of parent or affiliated companies. This presents a difficulty for foreign construction companies that might wish to incorporate a special-purpose vehicle (SPV) in a tax-efficient location to be the investor in the China FICE, insofar as it is the track record of this SPV that will be examined. This restricts the ability of foreign construction companies to structure their China investments in the most efficient and effective way.

Upgrading of Qualifications. Jian Shi [2003] No.73, issued by the MOC on April 8, 2003, mandates that newly established FICEs must apply for the lowest construction qualification grade, regardless of international experience, unless they previously held a Decree 32 qualification. The first qualification is issued as a one-year temporary qualification certificate. After receiving the temporary certificate, the FICE must wait for three years before it can apply to upgrade to the next qualification grade.

In addition, a FICE cannot use its overseas track record when it applies to upgrade its qualification grade but must rely only on its China track record. It should be noted that the recently issued Decree 114 Implementation Regulations allow a FIDE to use its investor's international track record to supplement its China track record, and to be consistent, the MOC should allow a similar relaxation to FICEs under Decree 113.

Use of Consortia. Large infrastructure projects are often awarded to a consortium of contractors, and this is a common approach to infrastructure procurement internationally. The PRC Construction Law permits two or more contractors to join together to jointly undertake construction projects; however, the Construction Law limits the consortium to undertaking projects within the lowest qualification grade held by the individual consortium members. The new draft Construction Law (released in August 2004) maintains this position. This is not consistent with international practice, where typically the capability of the consortium is assessed on the combined experience and resources of the consortium members and is not restricted by the lack of experience or resources of the perceived weaker partner.

Engineering and Design Sector – Decree 114. Decree 114 sets out the steps that must be taken and the qualifications that must be obtained in order for foreign engineering and design companies to undertake design activities in China. To undertake design works in China, a foreign engineering and design company must establish a local presence by setting up some form of Chinese legal entity (either a Wholly Foreign-Owned Enterprise (WFOE) or a Sino-Foreign Joint Venture (SFJV)), and this Chinese legal entity must, after establishment, apply for a design grade qualification (either Grade A, Grade B, or Grade C, in particular industry categories). Unlike in construction services, the opportunity exists for foreign engineering and design companies to undertake some design work offshore, insofar as Decree 78 allows foreign engineering and design companies to work in cooperation with locally qualified engineering design institutes if the offshore services involve engineering design beyond the basic initial conceptual (schematic) design stage.

Decree 114 Implementation Regulations. The final Decree 114 Implementation Regulations have now been issued, and the most notable features of the final regulations can be summarized as follows:

- The initial application by a foreign company to establish a FIDE can make use of the foreign company's overseas track record; any subsequent application to upgrade can also include the overseas track record, provided that at least two projects completed in China by the FIDE are included as well.
- Foreign qualifications of engineers and architects will be recognized and examined during the application process.
- The engineers and architects can be employed by only one design enterprise.
- Foreign-qualified and -licensed engineers and architects will be counted as part of the FIDE's staff requirements without the need for these individuals to pass the Chinese equivalent engineering or architectural exams.
- The FIDE can temporarily meet Decree 14's 25 percent minimum foreign service provider requirement by employing Chinese-licensed engineers and architects.
- The six-month residency requirement under Decree 114 may not be examined if it cannot be met temporarily.

While the final Decree 114 Implementation Regulations are a considerable improvement on the vacuum that previously existed, there remain a number of significant questions and uncertainties.

Personnel Requirements. Decree 114 mandates that large numbers of personnel are required in order to obtain relevant qualification certificates, and those foreign technical personnel must qualify as registered architects or registered engineers in China. For example, for a Grade A General Engineering Design qualification, the applicant must have no less than 500 technical personnel.

Under Decree 114, 25 percent of the foreign technical personnel of a wholly foreign-owned FIDE had to be qualified as registered architects or registered engineers in China, and foreign technical personnel had to constitute 25 percent of

the total key technical personnel employed by the wholly foreign-owned FIDE (the corresponding figure for SFJV FIDEs is 12.5 percent). Similarly, all foreign technical personnel (including engineers and architects) had to spend at least six months per year in China under Decree 114. The cost of maintaining such a high percentage of foreign technical personnel and getting them through the relevant Chinese registration process will not only significantly inflate the operating costs of the FIDE but also render the FIDE uncompetitive when viewed against Chinese design institutes.

The Decree 114 Implementation Regulations have "watered down" the 25 percent and 12.5 percent requirements, insofar as they allow the FIDE to "temporarily" meet its percentage requirement of foreign technical personnel who are qualified as registered architects or registered engineers in China, by hiring Chinese registered architects or registered engineers. The FIDE may also meet the percentage requirement of key technical personnel by employing Chinese technicians. In addition, the Decree 114 Implementation Regulations relax the six-month residency stipulation if it cannot be met "temporarily."

These relaxations have been warmly welcomed by foreign designers and engineers, but there is concern about the use of the word "temporarily," which implies an element of discretion on the part of the MOC.

Foreign Qualifications. The Decree 114 Implementation Regulations require the qualifications, experience, and reputation of the foreign technical personnel to be examined and any foreign registrations and licenses to be verified by the Practice License Registration Center of the MOC. No basis for such verification has been established, and the process of verification is not clearly articulated.

Track-Record Requirements. The Decree 114 Implementation Regulations allow a foreign engineering and design company's international track record to be used as part of its application for an initial FIDE qualification, and in fact two or more track records are required, with at least one track record having been completed in the FIDE's investor's home country. Once again, this restricts the use of SPVs as investors in FIDEs, and the track records of parents and affiliated companies should be open for examination.

Upgrading of Qualifications. Unlike Decree 113, Decree 114 allows newly established FIDEs to apply for Grade B or Grade C design qualification in their initial applications. The first qualification is issued as a two-year temporary qualification certificate. After receiving the temporary certificate, the FIDE must wait two years before it can apply to upgrade to the next qualification grade. Also unlike Decree 113, when a FIDE upgrades its qualification, it can make use of track records outside China, provided that at least two track records in China are included. This approach is in accordance with international practice, but to be consistent, the MOC should allow FIDEs to apply for Grade A qualifications in their initial applications.

Design-Tendering Concerns. On January 5, 2007, the MOC, the National Development and Reform Commission, the Ministry of Finance, the Ministry of Supervision, and the National Audit Office of China jointly issued an Opinion on Strengthening the Management of the Construction of Large-Scale Public Buildings ("the Opinion"). The Opinion was issued in an attempt to resolve a number of serious issues connected with the construction of large-scale public buildings, especially those in which the government had invested. According to the Opinion, some local governments are not acting in the national interest and are authorizing unrealistic "achievement projects" or "image projects" that do not emphasize conservation of energy and resources or use too much land. The Opinion sets out a number of principles for the procurement of large-scale public buildings (i.e., public buildings with a construction area of more than 20,000 square meters). In particular, the number, scale, and standards of such projects must be in keeping with national and local levels of development. Public buildings must be environmentally friendly and meet government requirements for quality and investment, and they must be in keeping with local history and culture as well as their surroundings.

While the general thrust of the Opinion is welcome and necessary, among the more controversial guidelines is one that encourages domestic tendering for construction and design plans and urges construction units "to avoid blindly conducting international tenders." The world of architecture can be a battleground. A building may be an eyesore to one person and an architectural gem to another. China is presently experiencing an outpouring of emotion over so-called ugly

buildings (see our previous *Commentary*, "Cultural Design Collision—China's Ministry of Construction Investigates Foreign Companies Involved in China's Construction Industry," September 2006). What appears to be causing great offense is that many of the allegedly "horribly designed" buildings are the works of foreign architects. In Beijing, for example, the works of some of the world's most renowned architects are coming under criticism and a debate is raging over who should shape the public face of China.

Building on this, the MOC in March 2007 has attempted to clarify the Opinion and has referred to the differing scales of fees charged by foreign designers when compared with Chinese designers. The MOC regards this as unfair and also criticizes foreign designers for "deviating from national conditions, seeking to unilaterally produce 'novel, peculiar and special' designs, which result in overly high construction and operational costs and even technical risks."

Many Chinese architects accuse their foreign counterparts of designing "white elephant" projects in China without regard to the country's cultural character. Foreign architects respond that they always try to ensure that their designs blend in with the local environment and culture. This cultural design collision is set to intensify with the issuance of the Opinion and its clarification, insofar as they assert that local designers should be favored over foreign designers in the award of design contracts for large-scale public buildings, which is a troubling development.

Project Management Sector – Circular 200. Up until the end of 2004, the project management market was not significantly regulated, and Decree 113 and Decree 114 did not apply to project management services. However, when Circular 200 took effect on December 1, 2004, it required that project management services could be provided only by local entities holding certain other construction-related qualifications, such as design, tendering agency, construction, supervision, and cost consultancy qualifications.

Foreign construction, engineering, and design companies have been providing project management services and expertise to foreign and Chinese developers for many years. Extensive transfer of project management technology has taken place, and Chinese contractors and developers have had the benefit of this expertise. Because project management companies are required to undergo the formal qualification process, with the registered capital, minimum personnel, and track-record requirements, foreign project management companies are disadvantaged and the transfer of technology to Chinese contractors and consultants will be significantly hampered. This cannot have been the intention of Circular 200, as this is inconsistent with the MOC's avowed intent to promote project management techniques and international best practices in China.

EPC Project Management Model. The engineering, procurement, and construction (EPC) model is a well-established international method of procuring large infrastructure projects. Under an EPC contract, a contractor is obliged to deliver a complete facility to the owner, who need only "turn a key" to start operating the facility. In addition to delivering a complete facility, the contractor must provide it for a guaranteed price by a guaranteed date, and it must perform to the specified level. Contractors who fail to comply with any requirements will usually incur monetary liabilities.

The MOC has been advocating the development of EPC contracting in China for many years and accordingly issued Order 30 on February 13, 2003, which aims to promote EPC and project management contracting in China. Unfortunately, the MOC has not gone further and enacted formal legislation to encourage the adoption of the EPC and project management models of contracting in China. In this regard, it is somewhat ironic that many Chinese contractors are undertaking EPC contracts in Africa, India, and the Middle East and yet are unable to obtain experience of this type of contracting in their own country.

It is also instructive to note that several provisions in the PRC Construction Law (restrictions on subcontracting and joint liability of contractors and subcontractors) conflict with international EPC contracting practice. Such provisions remain in the new draft Construction Law, and there seems to be some confusion between transferring the work (which should generally be permitted) and transferring responsibility for the work (which should be permitted only in exceptional cases where consent is given). As more and more international EPC

and project management procurement models are adopted in China and more innovative forms of financing are used, it will become obvious that these restrictions are not helpful (and in fact are an impediment) to the development of China's construction market.

Construction Project Services. Draft regulations governing foreign-invested construction service enterprises (FICSEs) were issued by the MOC on September 19, 2005, for consultation. These regulations have now been formally issued and come into effect on March 26, 2007. FICSEs are enterprises that engage in one or more of construction tendering, construction supervision, and construction costing services. The regulation sets out the establishment procedures as well as the specific qualification requirements. There are unlikely to be many foreign companies that chose to establish FICSEs as tendering, supervision, and costing are not areas where foreign companies can add value and compete effectively. Notwithstanding this new regulation, it remains unclear how project management fits into the MOC's regulatory scheme, particularly as Circular 200 was called a "provisional measure." We await further developments from the MOC in this regard.

Strategic Industry. In December 2006, the State-owned Assets Supervision and Administration Commission (SASAC) produced a guidance opinion on restructuring State-owned Enterprises (SOEs). The opinion outlined seven "strategic" industries where the state must maintain absolute control. A number of other industries were also highlighted as being "sensitive" and "fundamental to the national economy." These "sensitive" industries included survey, architecture, and design. Accordingly, foreign investors should be aware that any attempt to acquire an interest in an SOE involved in survey, architecture, or design will likely be subject to increased scrutiny from SASAC, and further, it might prove to be more difficult to obtain approval for the acquisition of more than 50 percent of an SOE involved in the survey, architecture, and design fields. This move is generally in line with the stricter merger and acquisition rules implemented in 2006 to restrict foreign control of sectors deemed to be vital to China's national interests.

CONCLUSION

The construction, engineering, and design sectors in China will continue to have high growth for several years to come. Many international construction, engineering, and design companies have come to China to take part in this development and to provide technical and managerial support to Chinese enterprises.

However, the situation for foreign companies remains somewhat uncertain and problematic, and while there have been positive steps in many directions, particularly with regard to the Decree 114 Implementation Regulations, there have nevertheless been further regulatory hurdles placed in the path of foreign companies attempting to undertake construction, engineering, and design roles in China.

This Commentary *was prepared with assistance from Li Hong, a legal assistant in the Beijing Office.*

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