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Regulating Municipal Water Supply Concessions

Accountability in Transitional China



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Preface

The past three decades have witnessed the fundamental achievements of China's marketization. Through this process, state-owned enterprises have been restructured, monopoly is giving way to competition and private sectors are increasingly participating in public service provision. The concept of concession was first introduced in public utilities through the Circular on Questions Concerning the Ratification of Pilot Foreign Invested Concession Projects (1995), after which there were many experimental projects with BOTs and TOTs. In 2002, with the issuance of Opinions on Accelerating the Marketization of Urban Utilities, the concession system was officially introduced in public utility regulation. In the same year, the water pipelines were opened to foreign investment; concessions have since been extended into integrated municipal water groups. Concessions have become the major approach of public utility provision.

In recent years, the accountability in concessions has raised wide concern. Problems exposed include fixed rate-of-return, state-owned assets losses, undue concession transfer, illegal concession award, unreasonable water tariff increase, and problematic service provision by private concessionaires. Commentators have claimed that an accountability gap exists in concessions. Taking water sector concessions as the subject of discussion, the author distinguishes three types of accountability: traditional bureaucratic accountability, legal accountability and public accountability. Through systematical examination of the problems, this book attempts to achieve a better understanding of concession and its application in public utilities, and finds that the alleged accountability gap is attributed to traditional bureaucratic accountability and concession system *per se*.

The efficiency of privatizing public utilities has been discussed for quite a while and the answer remains open. It is widely accepted that cookie-cutter approach to reform is unlikely to work. Thus, the argument of this book is not intended to promote concessions, but how to effectively utilize them in Chinese society. Four aspects of regulation in water concessions are considered: concessionaire selection, water pricing regulation, regulation by contract, and the regulatory framework. The findings suggest that under concessions, traditional bureaucratic accountability is

neither adequate nor appropriate to hold the government accountable. More formal legal rules on transparency, due process and public participation should be explored.

This book is based on my Ph.D. dissertation. With more recent literature added, the contents are extended and some chapters have been restructured. The data and reference have also been updated until 2013. During the course of writing and revision, I owe my greatest gratitude to many persons and institutions. First and foremost, special thanks are due to my supervisor, Professor Yu Guanghua, for his strict supervision, and insightful comments on my doctoral thesis. I have benefited a lot from his scholarship and supervision.

I thank the University of Hong Kong for their strong research resources for Ph.D. students including financial support for the international conferences from which I have gained the enlightening cross-disciplinary thoughts. I am grateful to Mr. Xu Zongwei who helps in easing my field trips for gaining the empirical information. I thank Mr. Yu Hui, Dr. Zhou Linjun, Dr. Cao Fuguo, Mr. Wang Aisheng, and Mr. Zhang Guoxiang for their time, patience, and experience exchange. Acknowledgement is also due to many other individuals, bureaus and institutions for their valuable assistance on my research. Although I cannot list them all, I am grateful to every one of them.

I am also indebted to the editors of the *Hong Kong Law Journal* and the *Australian Journal of Asian Law* for their kind acceptance of my papers. The comments from the reviewers help me clarify the points in a clearer and convincing manner. I cannot omit my heartfelt appreciation to the editors of the Springer publisher and the valuable comments from the peer reviewers. It would not have been possible to publish the book without their support and help.

Finally, my deepest gratitude goes to my family for their consistent patience, encouragement and love.

Shanghai, China

Yan Wei

Contents

1	Introduction	1
1.1	Characteristics of the Water Supply Sector.....	11
1.1.1	High Fixed Sunk Costs to Variable Costs	12
1.1.2	Public Health and Social Welfare Concerns	13
1.1.3	Local in Supply	13
1.2	Choices of Strategies in the Water Supply Industry.....	14
1.3	Economic Incentives of Water Supply Reforms in China.....	16
1.3.1	Water Supply Enterprises Operating at a Loss	17
1.3.2	Heavy Financing Stress and Low Efficiency	18
2	Concession Overview and Accountability Gap in China	21
2.1	Overview of Concessions and the Debate.....	21
2.1.1	Conception of Concessions.....	21
2.1.2	Debate on Concessions: Efficiency and Costs.....	24
2.2	Concessions in China.....	27
2.2.1	Policy Development in Water Supply Reforms	27
2.2.2	Typical Concession Structures.....	30
2.2.3	Legal Environments for Concessions	34
2.2.4	Legal and Policy Frameworks on Concessions.....	36
2.3	Accountability Concerns in China's Concessions.....	38
3	Restricted Competition in Concessions and Concessionaire Selections	43
3.1	Restricted Competition as a Worldwide Phenomenon.....	43
3.1.1	Oligopolies and Restricted Competition.....	43
3.1.2	Difficulties for New Competitors	45
3.2	Explanation for Restricted Competition in China.....	47
3.2.1	State Control for Market Entry	47
3.2.2	Traditional Bureaucratic Accountability	50

3.3	Concessionaire Selections and Criteria.....	60
3.3.1	Sole Sourcing and Transparency.....	60
3.3.2	IPPP Concessions	64
3.3.3	Rules for Proper Concessionaire Selections	67
3.4	Concluding Remarks.....	69
4	Water Pricing Regulations in the Context of Concessions	71
4.1	Controversial Returns on Investments	71
4.1.1	Fixed Rates of Return in Early Projects.....	71
4.1.2	Frequent Water Tariff Increase.....	73
4.2	Discussion on Water Tariff Increase	78
4.3	Alternative Explanation for Financing Constraints.....	80
4.3.1	Lack of Financing Capacity	80
4.3.2	Restrictions on Issuing Municipal Bonds	82
4.4	Why Concessions and the Facade	83
4.4.1	Economic Analysis	83
4.4.2	The Case of China.....	89
4.5	Institutional Framework for Transparency of Water Charging	90
4.5.1	Water Costs and Transparency.....	91
4.5.2	Ensuring More Effective Public Engagement.....	94
4.6	Concluding Remarks.....	96
5	Concession Contracts and Legal Accountability.....	99
5.1	Concession Contracts as a Regulatory Strategy.....	99
5.1.1	“Regulation by Contract”.....	99
5.1.2	“Incomplete Contract”	103
5.2	Legal Accountability in the Era of Concessions	104
5.2.1	The Applicable Laws for Concession Contracts.....	104
5.2.2	Judicial Embarrassment	110
5.2.3	Reconstructing Concession Contracts as “Economic Contracts”	117
5.2.4	The Mixing of Rules for Relief in Concession Contracts	119
5.3	Concluding Remarks.....	124
6	Regulatory Agencies and Structures Under Concessions.....	125
6.1	Regulatory Contract Enforcement Versus Economic Regulators	125
6.2	Water Regulatory Framework Status Quo.....	128
6.3	Restructuring Water Regulatory Framework	133
6.3.1	Property Rights Reform Versus Concession Policy	133
6.3.2	Regulatory Functions and the Proposed Regulator.....	139
6.4	Concluding Remarks.....	141

7 Conclusions and Implications	143
7.1 The Role of the Regulator and SOE Reforms	144
7.2 Transparency, Public Participation, and Public Accountability	145
7.3 Transcending Public and Private Laws	146
7.4 Judicial System Reform	147
Appendix: Questionnaires	149
Bibliography	151

Abbreviations

BOT Circular	Circular on Questions Concerning the Ratification of Pilot Foreign Invested Concession Projects
CPC	Communist Party of China
Measures 2004	Administrative Measures for Concession of Public Utilities
MOC	Ministry of Construction
MOE	Ministry of Electricity
MOHURD	Ministry of Housing and Urban-Rural Development of the People's Republic of China
MWR	Ministry of Water Resources
NDRC	National Development and Reform Commission
NPC	National Planning Commission
Opinions 2002	Opinions on Accelerating the Marketization of Urban Utilities
PPPs	Public-private partnerships
SASAC	State-owned Assets Supervision and Administration Commission
SEPA	State Environmental Protection Administration
SEZ	Shenzhen Special Economic Zone

Chapter 1

Introduction

Public goods that involve the daily and basic needs of citizens have long been provided and held accountable by the public sector. For the last few decades, private participation in public goods and services has been witnessed worldwide. The reform has been under the rubric of privatization, public-private partnerships (PPPs) and government reinvention,¹ and involves public authority administration, infrastructure provision, and natural resources development. The frequently cited reasons for privatization are a lack of expertise, capital and operating cost savings, and better services.² As to the infrastructure or public utilities sphere, the private sector helps rehabilitate, renovate and expand existing facilities; enhance technical and financial feasibilities of projects; satisfy public needs with greater efficiency; and share risks with governments.³ Infrastructure PPPs take many forms, which range from fully public to fully private. In between the spectrum, Savas listed service contract, operation and maintenance (O&M) contract,⁴ cooperative contract, Build-Own-Operate (BOO), Build-Transfer-Operate (BTO),

¹ In the 1990s, the Clinton administration sought to “reinvent government” by shrinking the federal workforce and infusing it with private-sector methods. After that, “the administration of President George W. Bush had pursued outsourcing even more aggressively.” In J. Freeman and M. Minow (eds.), *Government by Contract: Outsourcing and American Democracy*, (Cambridge, Mass. 2009), p. 8; Osborne and Gaebler argued that public goods provisions can be more efficient in private sector organization. This envisions a reduced government presence—“to steer rather than to row”, and a greater role for market mechanisms. See D. Osborne and T. Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector*, (Reading, Mass.: 1992).

² E. S. Savas, *Privatization and Public-private partnerships*, (New York; London: 2000), p. 238.

³ *Ibid.*, p. 240.

⁴ Private firms maintain and operate government-owned facilities; governments pay private firms a fee.

Build-(Own)-Operate-Transfer (BOT/BOOT),⁵ Wrap Around Addition, Buy-Build-Operate (BBO), and Lease-Build-Operate (LBO).⁶

The rise of private participation is accompanied by a contractual approach as the medium that forms the legal relations. The dynamic feature of a contractual approach to public services is the separation of the responsibilities in decision making from service delivery. Defined rights and duties are set in the contract intended to be binding.⁷ Through contracts, the private parties have the shared roles and responsibilities of governance, sometimes even into the territories once regarded as the exclusive jurisdictions of the state.⁸ The modern state is witnessing the increasingly closer links between the public and private, which lead to the blurring of boundaries, the increasingly intertwining of executive power with the market, democracy and equality, and the multi-identities of government which lead to interlacing among administration, economic management and state-owned assets operation.

The issue of accountability that accompanies the reform has come to the attention of the academia. Whether the implementation of privatization enhances or reduces the accountability needs to be answered. On a worldwide scale, this question has not yet received a definite answer. Some claim that privatization enhances the accountability, while others may argue otherwise. The United Nations (UN) documents promote privatization especially in developing countries, and believe that private participation can improve efficiency and accountability. Ian indicated that by separating the roles of “purchaser” and “provider”, the contracting state offers the opportunity “not only to pursue economic efficiency and effectiveness, but also enhance both individual rights and the accountability of the government for policy decisions.”⁹ Bishop, Kay and Mayer argued that privatization can promote the accountability.¹⁰ On the other hand, Minow contended that greater private involvement in traditional public sectors leads to loss of accountability.¹¹ The following quotation is her fundamental argument:

The urgent question posed by a shifting mix of public and private providers of education, welfare, and prison services is how to ensure genuine and ongoing accountability to the public.

⁵BTO, BOOT/BOT, and BOO apply when a new facility is to be built. In BTOs, private firms finance and build new facilities, transfer them to public ownership, and then operate them for 20–40 years, collecting user fees; BOOT and BOT are the same as BTO, but facilities are transferred to public ownership after 20–40 years; In BOOs, private firms finance, build, own, and operate facilities and collect fees, under perpetual franchises. E. S. Savas, note 2, p. 246.

⁶LBO, BBO, and wrap around addition are that existing facilities that require capital investment for expansion or rehabilitation. Private firms lease or buy facilities from governments, operate them under concessions, and expand or rehabilitate them, collecting user fees and paying franchise fees. In wraparound addition, private firms expand government owned facilities, own only the expansion, but operate entire facilities, collecting fees. *Ibid.*, p. 246.

⁷I. Harden, *The Contracting State*, (Buckingham: 1992), p. 29.

⁸J. Freeman, “The Private Role in Public Governance” (June 2000) *New York University Law Review* 543–675.

⁹I. Harden, note 7, p. xi.

¹⁰M. Bishop, J. A. Kay and C. P. Mayer (eds.), *Privatization and Economic Performance*, (Oxford: 1994).

¹¹M. Minow, “Public and Private Partnerships: Accounting for the New Religion” (2002–2003) *116 Harvard Law Review* 1229–1270.

Privatization of public services soared precisely when major corporations engaged in unfettered private self-dealing and one major religious group reeled from scandals, cover-ups, and mounting distrust among the faithful. This coincidence in timing should be all the reminder anyone needs of the vital role of public oversight and checks and balances.

Trebilcock delivered a commentary which points out that the flaws in private provisions claimed by Minow's are not adequate to justify extensive public intervention. Rather, the private sector is superior to public agencies in pursuing profit-seeking objectives and addressing principal-agent problems. Although there might be less legal and public accountability in private provisions, market-based accountability causes private sectors to behave as though they are public-spirited.¹² Saunders and Harris were also concerned that privatization has resulted in reduced accountability in which "the case of the water industry at least suggests that customers have gained little if anything from privatization, and that some may have lost".¹³

Since the 1990s, China has started a market-oriented reform of public utilities, focusing on introducing competition mechanisms, reforming management systems and experimenting capital diversification. The term concession, was first officially introduced in public utility reform by the Circular on Accelerating the Marketization of Urban Utilities (2002). Concessions apply in the utilities like water supply, gas supply, heat supply, public transportation, sewage treatment and garbage disposal. In reality, concessions can be referred to in different angles. One is as a market institution or system for introducing competition and could be featured as "competition for the market" to enjoy an exclusive right in the market. The market is therefore open to potential suppliers with contestability. The second position refers to the "concessionary right" that a concessionaire has been delegated. The protected right is carried on within an agreed period of time that the concessionaire agrees to provide the satisfied goods and services specified in a concession contract. Although the competitive factor in concessions is only at the entry stage, it is more considered as a *process*, involving the awarding procedures, monitoring, negotiation, and sanctions.¹⁴ Concessions are also treated as a new way of regulation in that regulatory provisions are in the concession contracts and the state retains the "controlling power (not) to renew the concession, and that commercial responsiveness and inventiveness can be facilitated in light-touch fashion through respect for managerial freedom."¹⁵ As China's concession practices work against a larger context of state-owned enterprise reforms, public authority transformations, and open policies, the understanding of concessions is also adopted in a broader sense that may be paraphrased as PPPs.

¹²M. J. Trebilcock and E. M. Iacobucci, "Privatization and accountability" (2002–2003) 116 Harvard Law Review 1422–1454.

¹³P. Saunders and C. Harris, *Privatization and Popular Capitalism*, (Buckingham: 1994), p. 75.

¹⁴C. Harlow and R. Rawlings, *Law and Administration*, 3rd ed., (Cambridge; New York: 2009), p. 394.

¹⁵*Ibid.*, p. 395.

The implementation of concession projects experiences both achievements and lessons. The problems exposed are cited as fixed rates of return, state-owned asset losses, undue concession transfers, and illegal concession awards.¹⁶ A typical example is the gas supply concession in Binzhou city (Hunan Province). Driven by financing incentives, the Binzhou municipal government signed a cooperative contract with the Hong Kong Huayan Company to develop gas pipelines in 2002. Afterwards, the latter did not invest into the project or take part in the operations. In 2004, a listed subsidiary of the Hong Kong Huayan Company was ordered to be suspended by the Hong Kong Securities and Futures Commission for false performance. This led to complete disruption of foreign capital chain. According to the cooperative contract, the project should provide gas to the first batch of users on February 1, 2003. However, only part of the first batch users was provided gas until October 2003. What's worse, the gas supply to end users was illegal without any safety inspections. Gas supply facilities were seriously deficient, and the ones in use had hidden trouble. The municipal government instructed corrective actions to be taken by the concessionaire, but the latter ignored the orders. As users were unable to access gas for a long period of time, the municipal government decided to grant another concession to a Hunan company. As the first concession had not been terminated, the Binzhou gas supply market was subsequently thrown into chaos.¹⁷ Similar problems of damaging the public interests also took place with the water supply¹⁸ and public transportation industries.¹⁹ In addition, with the introduction of private sector in water supply, increasing water tariffs have caused wide public criticism. Commentators have indicated that the gaps in government accountability are exposed in concession practices.²⁰

The objective of this book is to investigate the alleged accountability gap and try to fill the gap with a systematical analysis in the context of a transitional China. Four aspects of regulation—entry regulation, pricing regulation, regulation-by-contract and regulatory agencies are respectively analyzed. Prior to the discussion on accountability in concessions, we need to clarify the meaning and dimensions of accountability.

Accountability²¹ can be basically defined as accountable *for* something *to* someone. It is “the ability of one actor to demand an explanation or justification of

¹⁶Z. W. Xu, *Public Power Market*, (Beijing 2009), p. 239.

¹⁷For the details of this case, please refer to *Ibid.*, pp. 222–231.

¹⁸Y. F. Zheng, Hubei Nanzhang Dirty Water Incident Highlights the Absence of Government Responsibility in the Reform of Water Supply, *China Youth Daily*, (June 9, 2009), at http://news.xinhuanet.com/politics/2009-06/09/content_11510608.htm

¹⁹Z. Y. Zhang, “Privatization, Regulation Reform and the Arising of New Administrative Law” (2009) 2 *China Legal Science* 22–35.

²⁰T. Fu and L. J. Zhong, Urban Water Supply Reform: Problems and Trends, (July 3, 2013), at http://news.h2o-china.com/html/2009/07/813361246585768_1.shtml

²¹There is another term that can be used in the same wider sense, which is “responsibility”. Hart divided responsibility into four particular meanings, which are “role-responsibility” “causal-responsibility” “liability-responsibility” and “capacity-responsibility”, in which he understood the “responsibility” as “answerability” and can be moral or legal. H. L. A. Hart, *Punishment and*

another actor for its actions and to reward or punish that second actor on the basis of its performance or its explanation.”²² In other words, it is answering for one’s actions.²³ Davies decomposed an accountability mechanism into four key features.²⁴ They are: “setting standards against which to judge the account; obtaining the account; judging the account; and deciding what consequences, if any, should follow from it.”²⁵

For the first requirement, the standards determine the scope of the accountability process in that “they define which aspects of the relevant body’s responsibilities are covered by the process, and implicitly, which are not.”²⁶ In a contractual form, more flexible, precise and effective standards and acceptable performances are set as the contractual terms. The terms are potentially broad, concrete and autonomous. Standards in a contract can even exceed the statutory requirements for better performance.

The second component requires that actors be called to account orally or in writing. This is believed to be at the heart of accountability in that without information and explanations, the accountability process cannot take place.²⁷ It is especially so in long-term contracts which require continuous monitoring, such as “regular meetings or reports, rights of inspection and approval, and so on”.²⁸ This is very different from short-term contracts, in which a company can be called to account for their goods prior to payment, and if unsatisfactory, the products can be sent back.²⁹ Day and Klein distinguished accountability from account giving. It is the agreed obligation that translates giving accounts into accountability.³⁰ “When a public body voluntarily issues an annual report, it gives the accounts rather than being called to account,”³¹ as it has control of the report contents and the opportunity to gloss over details and facts. In contrast, the accountability triggered by the stakeholder or any other caller answers the exact questions raised or at the pre-agreed date set in the contract.³²

Responsibility: Essays in the Philosophy of Law, (Oxford: 1968), pp. 212, 264–265. Accountability and responsibility in this book are interchangeable unless otherwise explicitly defined.

²²E. Rubin, “The Myth of Accountability and the Anti-Administrative Impulse” (2004–2005) 103 *Michigan Law Review* 2073–2136.

²³G. A. Hodge and K. E. N. Coghill, “Accountability in the Privatized State” (October 2007) 20 *Governance* 675–702.

²⁴A. C. L. Davies, *Accountability: a Public Law Analysis of Government by Contract*, (Oxford; New York: 2001), p. 81.

²⁵*Ibid.*

²⁶*Ibid.*, p. 82.

²⁷*Ibid.*, p. 83.

²⁸*Ibid.*

²⁹*Ibid.*

³⁰P. Day and R. Klein, *Accountabilities: Five Public Services*, (London 1987), p. 5.

³¹A. C. L. Davies, note 24, p. 84.

³²Davies provided an example of the National Health Service (NHS) contract, “NHS contracts commonly included terms requiring the provision of reports on specified dates, with financial penalties if they did not appear.” *Ibid.*, p. 84.