

EIC Position Paper

on

Market Access Barriers in the Construction Sector in China

Introduction

European International Contractors (EIC) represents the interests of the European construction industry in all questions relating to its international construction activities. It has as its **members construction industry trade associations from 16 European countries**. In 2004, the total volume of international turnover carried out by EIC member companies outside the European Union amounted to more than 36 billion €.

Internationalisation and globalisation have a long tradition in the European construction industry, and projects and services provided by European international contractors are key factors in the economic and social development in countries in all regions of the globe. Due to the fact that the construction sector is globally subject to heavy domestic regulation, **European contractors** that engage in international trade in construction services generally **establish some type of foreign-based affiliate, Joint Venture or branch office abroad**. These forms of establishment allow the companies to deal adequately with national, sub-federal and even local regulations, e.g. control on land use, building permits, technical, qualification and registration requirements as well as environmental and safety laws.

Against this background, EIC advocates the principle of freedom of commercial presence abroad and opposes any respective discriminatory obstacles, such as restrictions on types of corporate entities, investment restrictions, nationality requests as well as restricted access to local utilities, which all have a great effect on the construction firms providing services in foreign markets. In addition, the effective market access for European international contractors depends on whether it is possible for them to compete on an equal basis for the public procurement of local construction projects. The absence of multilateral rules for procurement is sometimes considered as the most important non-tariff barrier affecting our sector. Since the launch of the so-called "GATS 2000 negotiations" in 1999, **EIC is co-operating closely with the European Commission (DG TRADE)** in order to **identify the many informal, often "invisible" trade barriers which exist globally in relation to construction services**, in particular with regard to the Chinese construction market.

According to the most recent statistics, **China** is already – behind the United States and Japan – the third largest construction market in the world. In 2005, construction spending amounted to around 242 billion US\$ and the average annual growth rate over the coming years is estimated at 6%. But albeit China has assumed the obligation to liberalise its services markets in connection with its accession to the World Trade Organisation (WTO) in December 2001, **European international contractors are still confronted with a number of market access barriers**, some of which are described further in this paper.

Situation on Chinese construction market before WTO Accession

The Registered Foreign Contractor System (“Decree No.32”)

In 1994, the Chinese Ministry of Construction (“MOC”) issued the *“Tentative Measures on Administration of Foreign Enterprise Skill Qualification for Contracting Construction Works within the Territory of China”* (“Decree No.32”).

Under Decree No.32, a foreign contractor who intended to undertake construction works in China on a project basis could obtain approval to carry out such work under the so-called **“Registered Foreign Contractor System”**. The approval process under this regime required the foreign contractor to apply for a skill qualification certificate, a project-specific business licence and a project permit to undertake the project in question. Such process essentially involved an assessment of the contractor’s global skills, expertise and project experience, i.e. acquired inside *and outside* of China.

The **types of work** which a licensed foreign contractor was allowed to undertake in China were, however, **limited** to the following:

- Projects which were entirely funded by foreign investment or grants;
- Projects which were funded by loans provided by International Financial Institutions and awarded through international open tenders;
- Sino-foreign Joint Venture projects which required technical expertise that Chinese contractors were unable to provide;
- Projects which were funded by domestic sources but difficult for Chinese contractors to undertake independently - foreign contractors were allowed to undertake these projects jointly with Chinese contractors with approval of the relevant construction authorities.

The Registered Foreign Contractor System and the possibility to acquire a **“Foreign Contractor Qualification Certificate”** did not force the foreign contractor to set up or maintain a significant presence in China, unless it had been awarded a project there. This system induced foreign contractors to come to China because their regular clients in their home countries had set up businesses in China and engaged them to carry out one-off projects like the construction of a manufacturing plant or facility.

Development on Chinese construction market after WTO Accession

Construction and Design Regulations (“Decrees No.113/114”)

Shortly after China’s accession to the WTO, on 27 September 2002, the MOC and the Ministry of Foreign Trade and Economic Co-operation (“MOFTEC”), now the Ministry of Commerce (“MOFCOM”), jointly issued the *“Regulation on Administration of Foreign Investment Construction Enterprises”* (“Construction Regulation” or “Decree No.113”) and the *“Regulation on Administration of Foreign Investment Construction and Engineering Design Enterprises”* (“Design Regulation” or “Decree No. 114”).

These two Regulations for the first time allow for **Wholly Foreign-Owned Construction Enterprises** (“WFOCE”) and **Wholly Foreign-Owned Construction and Engineering Design Enterprises** to be set up in China.

The Construction and Design Regulations are intended, however, to be read in conjunction with other laws and regulations, enacted only a few months before the accession of China to the WTO relating to foreign investment and the setting up of construction enterprises in China. These Implementation Measures specify in detail the requirements for the setting up of so-called **Foreign Investment Construction Enterprises** (“FICE”) which include both WFOCE and Sino-foreign construction Joint Ventures.

Repeal of the Registered Foreign Contractor System

Whilst the opening up of the possibility for foreign construction companies to establish WFOCE in China is concurrent with the commitments made by China upon WTO Accession in December 2001, the Construction Regulation at the same time violates these commitments, since it provides for the repeal of the well-established Registered Foreign Contractor System that had been in place in China for many years under Decree No.32. The introduction of Decree No.113 meant that, as of 1st October 2003, **foreign contractors could no longer obtain the “Foreign Contractor Qualification Certificate” to carry out business in China on a project basis.**

Upon intervention of the European Commission, the EU Chamber of Commerce in China and EIC, the entry into force of Decree No.113 was deferred by 6 months until 1st April 2004 with MOC Decree No.193, but was enacted thereafter. Full implementation was, however, again deferred until 01st July 2005 under Circular No.159 (*discussed below*).

Discriminatory national qualification system

With the entry into force of Decree No.113 the existing legal framework has deteriorated further to the extent that foreign contractors have to comply with new requirements, such as minimal registered capital and assets, minimum yearly turnover, minimum permanent personnel and the requirement that only qualifications obtained inside of China are accepted as references. Thus **the Chinese Government has imposed an unreasonable and disproportionate burden on foreign contractors** which *de facto* is closing the market to most FICEs.

1. Skill Qualification Classification of Foreign Invested Construction Enterprises

When deciding on the type of enterprise to set up and class of skill qualification to apply for, a foreign contractor apart from the Construction Regulations has to consider the following regulations:

- The “*Regulation on Administration of Construction Enterprise Skill Qualifications*” (“Decree No.87”) issued by the MOC on 18 April 2001 which sets out the requirements and procedures for the application of skill qualification for construction enterprises;

- The *"Implementation Opinion on the Regulations on Administration of Construction Enterprise Skill Qualifications"* issued by the MOC on 28 May 2001 which stipulates how Decree No.87 is to be implemented;
- The *"Construction Enterprise Skill Qualification Classification"* ("SQC") issued by the MOC on 20 April 2001 which sets out the qualifying standards for different classes of skill qualification for construction enterprises in the various industries and disciplines;
- The *Implementation Measures*.

These Implementation Measures specify the types of enterprise that are entitled to obtain a *Skill Qualification Classifications* ("SQC"), the classes of SQC available, the track record requirements as well as staff qualification requirements. Under this new legal framework, any FICE has to comply with an **onerous national qualification system that places it at a disadvantage compared to the local contractors**. For instance, whilst it is possible that a FICE employs "foreign service providers" to satisfy these requirements, they must satisfy certain conditions set out in the SQCs and Implementation Measures, e.g. in relation to educational qualifications, experience and residency requirements.

If an applicant is unable to obtain a SQC, then it is not allowed to undertake any work, even if it has obtained a business licence prior to the application for a SQC. The Construction Regulation, therefore, provides for a preliminary examination of the application by the relevant construction authority before approval is given by the local MOFCOM office (or MOFCOM at the national level). If the applicant is unable to satisfy the construction authority at the preliminary examination stage, the local MOFCOM office or MOFCOM will not issue their certificate of approval.

However, even if the applicant is able to satisfy the construction authority at the preliminary examination stage, there is no guarantee that the SQC will in fact be issued, as further conditions might be imposed subsequently. One of these conditions may be for the applicant to pay in full its registered capital prior to the issue of the SQC whereas foreign investment laws and regulations generally allow foreign investment enterprises to make payment of its registered capital in a number of instalments over a longer period of time.

2. Wholly Foreign Owned Construction Enterprises ("WFOCE")

Under the Construction Regulation, **the operational freedom of WFOCEs is restricted more or less to the same types of work as before China's WTO accession** under the Registered Foreign Contractor System. There is only one small difference, as WFOCEs can undertake Sino-foreign Joint Venture projects where the foreign investment is equal to or greater than 50%. In essence, the scope of action for foreign contractors remains limited to

- Projects which are invested or funded entirely by foreign investment or grants;
- Projects which are funded by International Financial Institutions and awarded through international tendering in accordance with the provisions of the loan documents;
- Sino-foreign joint venture projects where the foreign investment is equal to or greater than 50%, or Sino-foreign joint venture projects where the foreign investment is less than 50% but due to technical difficulties, Chinese contractors are unable to undertake the projects independently;

- Domestic invested projects which due to technical difficulties, Chinese contractors are unable to undertake independently - such projects may be jointly undertaken with WFOCEs.

The above restrictions mean that WFOCEs have to satisfy all the requirements which Chinese contractors of the same class have to satisfy, including the minimum amount of registered capital, management and technical personnel requirements, number of projects to be carried out each year, etc, but their **market is limited to the four categories of projects** set out above. In addition, **the Chinese qualification system does not generally take into consideration those references obtained outside of China**. These discriminatory provisions make WFOCEs less attractive to foreign contractors as vehicles for long term investment in the Chinese construction market, although most foreign contractors at present are only interested in tendering for the type of projects available for WFOCEs.

3. Sino-Foreign Joint Ventures

The restrictions on the types of work that WFOCEs can undertake do not apply to Sino-foreign construction Joint Ventures. These Joint Ventures can undertake the same projects as domestic Chinese contractors as long as these projects are within the scope of their Skill Qualification Classifications (SQC).

However, the Construction Regulation strictly regulates the freedom of operation of Sino-foreign Joint Ventures. For instance, if a foreign construction company wishes to form a construction Joint Venture with a Chinese party, the interest of the Chinese party in such a Joint Venture must not be less than 25%. The track record to be considered is the combined track record of the foreign and the Chinese parties. If, however, the Chinese party has already made use of its track record for other SQC applications, then **the track record might not be available for the Sino-foreign Joint Venture, whilst the track record of foreign contractors is not taken into consideration**. For existing Sino-foreign Joint Ventures, their skill qualifications are subject to **reassessment in case of a merger with or acquisition by a foreign contractor** in order to ensure that they comply with the requirements of the Skill Qualification Classifications.

Circular [2004] No.159

Due to the request of certain WTO Members, the Chinese Government introduced on 6 September 2004 the *“Circular on Several Issues regarding the Administration on qualifications of Foreign-Invested Construction Companies”* (“Circular No.159”) which interprets the Decree No.113 for a transition period. According to this Circular, if a foreign contractor has obtained the approval certificate for the establishment of a FICE, but such FICE has not yet obtained the requisite construction enterprise qualification certificate, such foreign contractor is permitted to continue to use its “Foreign Contractor Qualification Certificate” to undertake construction projects in China through 1 July 2005.

With regard to the evaluation and determination of the level of construction enterprise qualification certificates for FICE under Decree No.113, the Circular allows the performance of a foreign contractor outside China to be taken into account in determining the qualification level of the Decree No.113 Joint Venture/WFOCE established by such foreign contractor.

The Circular also states that a Decree No.113 entity may employ “foreign service providers” to be its technical, engineering and managerial personnel. Such foreign service providers must have professional qualifications equivalent to those set out in the “*Notice Concerning the Issuance of the Measures of the MOC for the Administration of the Qualifications by Implementing the Provisions on the Administration of FICE*” (Circular [2004] No.73) and other relevant Chinese rules. The Circular further provides that an entity established in accordance with Decree No.113 can employ foreign service providers as project managers and it also has removed the requirement on the minimum number of expatriate project managers to be employed by such entity as set out in the above mentioned MOC Measures.

However, the Circular leaves a **large amount of discretion to the competent Chinese authorities**, since the relevant passages read that “*construction credentials of foreign investors may be taken into account*” and that “*FICE may employ foreign service providers...*”. It is entirely unclear how Chinese authorities will apply this discretion. In this context, it should also be noted that the Chinese government has recently decentralised with Circular No.76 [2006] the establishment approval for Decree No.113 which might contribute to even more uncertainty with regard to administrative practice.

Conclusion and Evaluation

EIC perceives that the relevant rules in the year 2006 are still very restrictive. The limitations to the operational freedom of foreign contractors discriminates and should be removed. The Construction and Design Regulations, although purporting to open up the construction market in China to foreign participation, have made it more difficult for European international contractors to undertake eligible projects in China, since they do require foreign contractors to restructure their existing corporate entities in China. Apart from the limited extension of Decree No.32 and the relaxation of some requirements for the setting up an FICE under Decree No.113, the Circular No.159 has not contributed to any significant improvement of the situation of foreign contractors.

From a legal perspective, the WTO compatibility of the new legal framework for foreign construction services in China has to be seriously queried in relation to the so-called “*grandfathering clause*” and in relation to GATS Articles VI [*Administration of domestic regulation*] and XVII [*National Treatment*]:

Repeal of the Registered Foreign Contractor Status

EIC holds the opinion that by abolishing the Registered Foreign Contractor Status, China is violating its horizontal WTO commitments which stipulate that:

The conditions of ownership, operation and scope of activities, as set out in the respective contractual and shareholder agreement or in a license establishing or authorising the operation or supply of services by an existing foreign service supplier, will not be made more restrictive than they exist as of the date of China’s accession to the WTO (“grandfathering”).

Modalities of the existing legal framework

As concerns the Chinese qualification requirements on **minimum amount of registered capital, management and technical personnel, number of projects to be carried out each year** and considering the fact that the Chinese qualification system does not generally take into consideration **references obtained outside of China**, EIC holds the opinion that such practice is contrary to **GATS Article VI [Administration of domestic regulation]** which establishes the principle that *“all (domestic) measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner”*. In particular, *“qualification requirements and procedures, technical standards and licensing procedures [must] not constitute unnecessary barriers to trade in services”*. Furthermore, there is no remedy foreseen that foreign suppliers are able to challenge the administrative decisions under the new qualification system.

As a consequence, there is also a violation of **GATS Article XVII [National treatment]**, which provides that *“formally identical treatment shall be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or services suppliers of any other Member”*. The benchmark here is the *de facto* discrimination of the foreign service provider resulting from the application of general measures, since Chinese construction companies are normally in a better position than foreign contractors to meet the said requirements.

Other “invisible” Market Access Barriers

For international construction contracts the application of International Arbitration is an important tool to resolve disputes between the local client and the foreign contractor. **Article 16 of the 1994 Arbitration Law of the People’s Republic of China** provides that for an arbitration agreement to be valid, it must contain *“a designated arbitration commission”*, whilst the most frequently used Standard ICC Arbitration Clause states only that *“All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules”* and, therefore, does not make a reference to a designated commission. Hence, the requirements of Chinese Arbitration Law thwarts the validity of international arbitration agreements and enforcement of awards, and has resulted in challenges in the past on jurisdiction.

Last but not least, with regard to **private construction contracts involving Sino-Foreign Joint Ventures with a foreign majority interest** as clients, the Articles of Association of such Joint Venture in some cases provide for the right of the Chinese minority shareholder to obstruct the award and execution of a construction contract commissioned by such Joint Venture through a foreign contractor.

Appeals of the European Construction Industry

EIC calls on the European Commission to negotiate with the Chinese Government better market access conditions for European international contractors, including as well their construction-related services, on the Chinese construction market. The actual operation restrictions for foreign contractors should be reduced through the following measures:

- 1. A resumption of the former Decree No.32 or, alternatively, an extension of types of work allowed for international contractors;**
- 2. The implementation of licenses for project management, construction management and other construction-related services;**
- 3. More flexibility in the application of the capital and asset requirements and the approval of internationally well-established banking instruments, such as bank guarantees, insurance bonds, Letters of Credit, etc.;**
- 4. The mandatory acknowledgement of international references and the grading of Sino-foreign consortia and Joint Ventures according to the upper qualification grades of the two entities.**
- 5. In case of an acquisition of a local construction company by or a merger with a foreign company, the Chinese authorities may not be entitled to re-assess the skill qualification of that local company, as this would retroactively threaten the value of the transaction.**

Berlin, 05th July 2006