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By Email

Australia-China FTA submission: Market access issues in China's construction, engineering and project management service sectors

1. Introduction

China's post-WTO construction and design regime has opened the industry to greater foreign participation, but has also introduced significant obstacles to foreign competitors. This submission sets out a number of the key market access problems that Australian construction and design companies are facing in the Chinese market and makes recommendations regarding negotiating priorities in this important sector. The authors of this submission are both Australian lawyers currently practising with a major international law firm in Shanghai.[1] Over the course of the last

[1] John Cole has been a strategic adviser to major multinational companies involved in project development, construction and financing in the Asia Pacific region for the past 12 years. He was formerly in-house counsel with Bechtel for the Asia Pacific region. John is the Chair of the European Union Chamber of Commerce ("EUCCC") Shanghai Construction Working Group ("CWG"). Ruth Hill's practice covers a wide range of issues relating to foreign direct investment, technology licensing and construction and design work in China. Ruth is a member of the EUCCC Shanghai CWG and the Australian Chamber of Commerce Shanghai Construction and Property Industry Working Group ("CPIWG").

few years they have been actively following developments in China's construction and design regulatory regime and have corresponded with the Ministry of Construction ("MOC") on a number of the regulatory issues discussed in this submission.

2. Opportunities and Challenges

There are currently significant opportunities for Australian companies in China's construction and design market. In particular, demand in China is currently running very high for infrastructure-related construction, including roads, rail systems, bridges, and ports, as well as resource-based construction, including mining, large-scale oil and gas projects, and alumina and nickel refining projects. Australian construction and design companies have considerable experience in these industries and stand to benefit considerably from increased opportunities for participation in the Chinese market.

Australian companies wishing to participate in the Chinese construction and design services market are, however, currently facing a number of challenges. By way of summary, these include restrictions on wholly foreign-owned enterprises participating in certain market segments, significant registered capital requirements, nationality-based population requirements and regulatory uncertainty, compounded by a lack of consultation and notice prior to the issuance of new regulations.

Since the introduction of the post-WTO construction and design regulatory framework in 2002, members of the foreign construction and design community have raised their concerns regarding a number of key aspects of the regime. In respect of the construction regime, foreign companies have raised their concerns regarding the significant registered capital requirements and the harshness of the China experience requirements. In respect of the design regime, concerns have been raised regarding the nationality-based population requirements. The MOC has shown flexibility with respect to a number of these issues. For example, in accordance with a Circular issued in September 2004, foreign construction companies may now count experience gained outside of China in qualifying under the domestic qualification regime.[2] However, with respect to other issues, such as the significant registered capital requirements, the MOC has been resolute in its refusal to allow any concessions for foreign-invested enterprises.

The aim of this submission is to distil a list of issues which are both of concern to Australian companies, and are issues on which we believe the MOC may be willing to show some flexibility. In this regard, we have looked to the Closer Economic Partnership Arrangement ("CEPA") between Hong Kong and the mainland, and have recommended that Australia seek a number of concessions similar to those granted to Hong Kong construction and design service suppliers under this agreement. We have also sought to emphasise the particular strengths of Australian construction and design companies in infrastructure and resource-related construction projects, and have recommended that Australia seek concessions relating specifically to these industry sectors on the grounds that, firstly, China stands to gain considerably from Australian expertise in these areas and, secondly, that China is unlikely to grant concessions in the housing and office construction sectors for domestic policy reasons.

In line with the structure of the Chinese regulatory regime, we have organised the recommendations in this submission into following sections (i) construction services, (ii) engineering design services (hereafter referred to simply as "design services", in conformity with applicable regulations) and (iii) project management services.

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[2] *Notice on Issues Regarding the Administration of the Qualifications of Foreign-Invested Construction Enterprises*, issued September 2004 ("Circular 159").

3. Construction

3.1 Background

Foreign investors are now permitted to establish wholly foreign-owned enterprises ("WFOEs"), cooperative joint ventures and equity joint ventures to undertake construction work in China.[3] Such entities must be appropriately qualified under the domestic construction qualification regime. This regime is based on a grading and categorisation system. The grading rules are complex and are different for construction enterprises working in different industries. For each grade and category enterprises must establish that they meet certain requirements regarding experience, personnel and registered capital.

3.2 Scope of Work

Construction WFOEs in China are restricted to undertaking certain types of projects.[4] Specifically, construction WFOEs are generally limited to undertaking projects that are either wholly or partly financed by foreign investment or cannot be undertaken by Chinese construction enterprises for technical reasons. With respect to Sino-foreign joint construction projects, construction WFOEs are restricted to undertaking projects in which foreign investment accounts for 50% or more of the total investment.

CEPA exempted certified Hong Kong construction companies from foreign investment restrictions when undertaking Sino-foreign joint construction projects. It is not clear whether this exemption was intended to extend as far as permitting certified Hong Kong construction companies to undertake work for wholly Chinese-invested projects. MOC officials that we have spoken to have indicated that the exemption does extend to wholly Chinese-invested projects. We recommend that Australia seek a similar concession, particularly with respect to construction projects in which Australian companies have particular experience and expertise.

China has legitimate domestic policy reasons for not allowing construction WFOEs to undertake residential and office construction projects in China. We believe, however, that there are strong grounds for arguing that Australian-invested construction WFOEs should be permitted to undertake work for wholly Chinese-invested projects in the mining and metals, power, oil and gas and other infrastructure and resource-based sectors. This would significantly increase the opportunities available to Australian contractors in the Chinese market. It would also allow China to benefit from the considerable experience and expertise that Australian contractors have in these sectors.

Recommendation: *Remove the foreign investment restrictions on Australian-invested construction WFOE's undertaking Sino-foreign joint construction projects outside of the residential and office sectors.* (This is the language used in CEPA, amended to exclude the residential and office sectors.)

3.3 Working in Consortiums

Two or more construction companies are permitted to undertake construction work in China as a consortium. However, where two or more companies with different qualification grades jointly

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[3] *Regulations on the Administration of Foreign-invested Construction Enterprises*, issued September 2002 ("Decree 113").

[4] The relevant restriction is contained in Article 15 of Decree 113.

undertake a construction project they are currently limited to operating within the business scope of the company with the lowest qualification grade.[5]

New entrants to the Chinese construction market are generally required to commence operations at the lowest grade for each category in which they qualify (although we understand that in practice there have been exemptions to this requirement). As such, Australian contractors in China are likely to hold qualifications at the lower grades. We recommend that Australia seek an exemption from the consortium qualification restriction outlined above to allow Australian and Chinese contractors working in a consortium to contract for work within the higher of the two qualification grades.

From a regulatory point of view, if the companies in the consortium are jointly and severally liable, there should be no problem allowing them to undertake work within the higher qualification level (since, in theory, the entities are jointly and severally liable for the project). Australian contractors would benefit from such an arrangement in that they would be able to team up with and utilise the qualifications of well-established Chinese contractors. This would enable them to contract for larger projects than they otherwise would have been able to, thus increasing the opportunities available to them in the Chinese market. Further, they would be able to do so without having to qualify themselves under the higher grades and in so doing tie-up considerable sums of capital in meeting the significant registered capital requirements of the higher grades. Chinese companies would benefit from such an arrangement in that it would facilitate knowledge transfer from Australian contractors to Chinese contractors, particularly in relation to larger infrastructure and resource-based projects in which Australian contractors have particular expertise. Relaxing the consortium qualification restriction just for Australian-invested companies would also allow the Chinese regulators to trial the operation of such a concession, without committing to introducing it across the board.

Recommendation: *Allow Australian-invested construction companies working in a consortium with Chinese companies to work within the higher of the two companies' qualification grades.*

3.4 Residency Requirements for Foreign Personnel

Foreign personnel employed by foreign-invested construction companies are required to be resident in China for three months each year.[6] This creates an unnecessary cost for foreign-invested construction companies. Parent companies will naturally dispatch qualified foreign personnel to their China subsidiaries as needed. Such personnel are, however, often only required on a short-term basis. Requiring foreign-invested construction companies to keep foreign personnel resident in China for a minimum of three months each year creates an unfair burden, particularly for smaller, highly specialised firms.

The Supplement to CEPA signed on 27 October 2004 exempted Hong Kong personnel employed by certified Hong Kong construction companies from this requirement. We recommend that Australia seek a similar exemption from this requirement.

Recommendation: *Remove the 3 month residency requirement for foreign individuals employed by Australian-invested construction companies.*

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5 The relevant restriction is contained in Article 19 of Decree 113.

6 The relevant restriction is contained in Part IV(5) of the *Implementing Measures Concerning Construction Industry Qualifications for Foreign-Invested Enterprises*, issued April 2003 ("Decree 73").

4. Design

4.1 Background

Design services have also opened to foreign investors, however, wholly foreign-owned design entities may currently only be established by Hong Kong design firms qualified under CEPA. Other foreign investors may only establish design WFOEs from December 2006 and, in the meantime, are restricted to joint ventures.[7] As is the case for foreign-invested construction companies, foreign-invested design companies must be qualified under the domestic design qualification regime.

4.2 Wholly Foreign-owned Entities

Certified Hong Kong design companies have been given a head start in the Chinese market with design companies wholly owned by certified Hong Kong design companies permitted ahead of the December 2006 WTO schedule. This has allowed Hong Kong design companies to get a foothold in the market ahead of their international competitors. We recommend that Australia seek a similar head start in the Chinese design market by requesting that wholly Australian-owned design companies be permitted to set up in the mainland as soon as possible and, in any case, ahead of the WTO schedule. This would provide a head start for Australian design companies and would encourage international design companies to invest in China via their Australian subsidiaries.

Recommendation: *Allow Australian-invested design WFOE's to be established as soon as possible and, in any case, prior to the December 2006 WTO commitment.*

4.3 Personnel Requirements

A design WFOE must employ the minimum number of key technical personnel stipulated for its qualification category and grade. Of this number, one quarter must be foreign personnel with relevant design experience.[8] Design WFOEs must also employ a minimum number of certified architects and certified engineers qualified in China. Of this number, one quarter must be foreign personnel who are qualified as certified architects or engineers in China. Design joint ventures are subject to similar foreign personnel requirements, although the required proportion of foreign personnel is one eighth.

It is unclear whether a foreign national may sit the Chinese professional examinations on anything more than a case-by-case basis. Further, sufficient language skills will be lacking for many otherwise suitable professionals. Adopting a standards-based approach to market regulation, without any reference to foreign personnel requirements or nationality-based criteria, will improve the quality and efficiency of the design market in China. Nationality-based qualification requirements inhibit these efforts.

The quota regarding the number of foreign project managers to be employed by foreign-invested construction companies was recently removed.[9] This may indicate that the MOC may be amenable to removing the quotas on minimum numbers of foreign professionals for foreign-invested design companies. In addition, a mechanism for the mutual recognition of certain

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[7] *Regulations on Administration of Foreign-invested Construction Engineering and Design Enterprises*, issued September 2002 ("Decree 114").

[8] The relevant restriction is contained in Article 15 of Decree 114.

[9] The concession was granted under Circular 159.

professional qualifications between Hong Kong and the mainland was introduced under CEPA. Specifically, agreements were entered into under which the qualifications of structural engineers and architects from Hong Kong are now recognised in the mainland subject to such professionals meeting certain requirements. Such professionals must also undertake fourteen hours of training, sit a one hour multiple choice test and attend a 20 minute interview organised by the relevant regulatory body in China. The training, test and interview are offered only in Mandarin Chinese (written materials are in traditional characters) and are held once a year.

We recommend that Australia seek an exemption both from the quota of qualified foreign professionals and from the requirements to employ a minimum number of foreigners qualified in China. Alternatively, or additionally, we recommend that Australia seek the implementation of a system for the mutual recognition of professional qualifications similar to the one in place under CEPA. We believe that this will have a number of advantages for Australia. Firstly, getting Australian engineering and architectural qualifications accepted will increase employment options for Australian engineers and architects in China (not only with Australian-invested design companies, but generally within the Chinese design industry). Secondly, it will also increase the perception of Australia as a leading destination for education in the technical disciplines.

Recommendation: *Exempt Australian-invested design companies from the population requirements and/or provide for the recognition of the qualifications of Australian engineers and architects.*

4.4 Residency Requirements for Foreign Personnel

The foreign personnel of design WFOEs are also subject to residency requirements. Specifically, a design WFOE's foreign personnel must reside in China for a cumulative six months each year.[10] As outlined above, the corresponding residency requirements were removed for construction enterprises established in the PRC by certified Hong Kong construction companies under the Supplement to CEPA. We recommend that Australia seek a similar exemption from this requirement under the design regime.

Recommendation: *Remove the 6 month residency requirement for foreign individuals employed by Australian-invested design companies.*

5. Project Management

5.1 Background

Project management is not a well developed discipline in China. Historically all construction and design projects in China were government funded and run. As such, "project management" consisted largely just of scheduling. Much of the substantive project management work undertaken in China to date for foreign funded major projects and infrastructure has therefore been undertaken by foreign-invested companies.

The regulatory landscape applicable to the provision of project management services in China has recently changed. Prior to December 2004 project management was largely unregulated in China. Foreign companies wishing to provide project management services could do so without having to obtain a formal qualification from the MOC. This situation changed with the introduction of the *Trial Measures Concerning Construction Project Management*, in December 2004 ("Circular 200"). Circular 200 stipulates that companies wishing to provided project management services in China must be qualified under one or more of the following six construction-related

[10] The relevant restriction is contained in Article 16 of Decree 114.

regimes, respectively: (1) construction, (2) design, (3) costing, (4) tendering, (5) supervision (监理) or (6) surveying.

5.2 Avenues for Qualifying

The only avenue currently available for WFOEs wishing to provide project management services in the PRC is to be licensed as a construction company under Decree 113 (or, exceptionally for some CEPA eligible companies, as a design company under Decree 114). There is currently no regulatory path for Australian-invested companies to apply for and obtain qualifications for construction supervision, project cost-consulting, tendering agency or surveying services.

The MOC has indicated that it does not intend to introduce a specific project management qualification in the future.[11] Australian-invested construction companies wishing to offer project management services in the PRC are therefore required to qualify under Circular 200 in one of the listed disciplines. Qualifying as a construction company under Decree 113 is simply not a realistic option for many Australian companies in the project management sector. The high registered capital requirements make such an option commercially unfeasible. Australian companies therefore need to qualify in one of the other disciplines.

We recommend that Australia seeks the implementation of a framework under which Australian-invested WFOEs can qualify as costing agencies, supervision (监理) entities, and tendering agencies. The MOC has indicated that regulations which would set out such a path, the *Regulations Regarding the Administration of Foreign Investment Construction Service Units*, are currently being drafted. We recommend that Australian-invested companies be permitted to establish such companies as WFOEs as soon as possible and, in any case, ahead of the implementation of such regulations as a form of pilot scheme.

Recommendation: *Allow Australian-invested WFOEs to qualify as costing agencies, supervision (监理) entities and tendering agencies as soon as possible.*

5.3 Project-by-project Licences for Specialised Work

Circular 200 requires entities providing project management services in China to be qualified under one of the construction-related regimes. This prevents foreign project management service providers with specialised experience and expertise who do not have a business case for establishing and qualifying an entity in China from undertaking project management work within their areas of specialty in China.

We recommend that Australia seek a project-by-project licensing system for Australian companies to undertake project management work in China in areas where Australian companies have particular expertise and would otherwise not have a business case to establish an entity in China. Allowing Australia companies to provide project management services under such a project-by-project licensing scheme would allow companies offering specialised services to come to China to undertake specialised work, such as oil & gas or power projects, on a case-by-case basis. Without such a scheme, China will miss out on the expertise of such specialist contractors.

Recommendation: *Introduce a project-by-project licensing system for Australian companies to undertake project management work in China in areas where Australian companies have particular expertise and would otherwise not have a business case to establish an entity in China.*

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[11] This was indicated in a letter addressed to the European Union Chamber of Commerce in China dated 22 March 2005 (an unofficial translation of which is attached for your reference).

6. Policy Analysis

We believe that the concessions outlined above will both give Australian companies a leg-up in the Chinese market, as well as encourage investment in Australia by global construction and design companies keen to set up Australian subsidiaries to take advantage of the new concessions. Further, we believe that the successful negotiation of the types of concessions outlined in this submission will provide incentives for global engineering and construction companies to establish regional headquarters in Australia.

As outlined above, we believe that implementing a system for the mutual recognition of engineering and architectural qualifications between Australia and China will increase the perception of Australia as a leading destination for education in the technical disciplines and reinforce our reputation as a knowledge economy.

7. Transparency and Consultation

The foreign-invested design and construction community in China claims that a lack of transparency and consultation in the development of the construction and the design regime has created uncertainty. They argue that this uncertainty is impacting the ability of foreign companies, including Australian companies, to do business in China. An oft-cited example is the unexpected release of Circular 200. Circular 200 was released without any opportunity for comment and took effect within a fortnight of its release. The argument follows that, as a result, the viability of many members of the Australian construction and design community was thrown into question. Copies of correspondence between the European Union Chamber of Commerce in China and the MOC on this point are attached for your reference.

We recommend that Australia take the opportunity presented by the Australia-China FTA negotiations to raise these issues with the Chinese regulators and encourage them to engage in industry consultation prior to implementing regulatory change.

Recommendation: *Request Chinese regulators to provide more notice and engage in consultation with interested industry participants prior to issuing new regulations.*

8. Conclusion

There are currently significant opportunities for Australian construction and design companies in China. Australian companies wishing to participate in the Chinese construction and design services market are, however, facing a number of market access issues. In order to ameliorate these difficulties, this submission recommends that Australian negotiators prioritise the following concessions in respect of the construction, design and project management service sectors:

1. *Remove the foreign investment restrictions on Australian-invested construction WFOE's undertaking Sino-foreign joint construction projects outside of the residential and office sector.*

2. *Remove the 3 month residency requirement for foreign individuals employed by Australian-invested construction companies.*

3. *Allow Australian-invested construction companies working in a consortium with Chinese companies to work within the higher of the two company's qualification grades.*

4. *Allow Australian-invested design WFOE's to be established as soon as possible and, in any case, prior to the December 2006 WTO commitment.*

5. *Exempt Australian-invested design companies from the population requirements and/or provide for the recognition of the qualifications of Australian engineers and architects.*

6. *Remove the 6 month residency requirement for foreign individuals employed by Australian-invested design companies.*

7. *Allow wholly Australian-invested companies to qualify as costing agencies, supervision (监理) entities and tendering agencies as soon as possible.*

8. *Introduce a project-by-project licensing system for Australian companies to undertake project management work in China in areas where Australian companies have particular expertise and would otherwise not have a business case to establish an entity in China.*

9. *Request Chinese regulators to provide more notice and engage in consultation with interested industry participants prior to issuing new regulations.*

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For your reference, further details regarding the construction and design regulatory regime in China are set out in the attached document ("China's Design and Construction Regime"). We invite questions and comments on our submission and would be very happy to provide further details by way of a telephone conversation or a meeting if required.

We have no objection to this submission being posted on your website, but request that the attachments to the letter not be made publicly available.

Yours sincerely

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