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A scenic landscape photograph of a mountain valley. In the foreground, a blue truck is driving on a dirt road. The middle ground shows a valley with green hills and a river. In the background, there are more mountains under a blue sky with some clouds.

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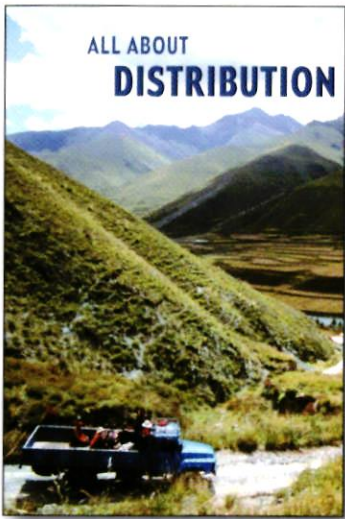
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short takes

United States and China Resolve Outstanding WTO Issues

The United States and China have reached a "consensus" on issues concerning China's accession to the World Trade Organization (WTO). The agreement clears the way for China to enter the WTO, possibly by the end of the year. In meetings during the Asia Pacific Economic Cooperation (APEC) Forum Trade Ministers meeting in Shanghai on June 6-7, teams led by PRC Foreign Trade and Economic Cooperation Minister Shi Guangsheng and US Trade Representative Robert Zoellick negotiated solutions to the final sticking points in the agricultural, insurance, distribution, and retail sectors.

Shanghai Sets Up APEC Hotline

Shanghai has set up a hotline for suggestions and complaints about preparations for the upcoming APEC summit. The hotline, which will operate from May 19 to October 31, has service in both English and Chinese. The hotline number is 82001. Callers outside Shanghai should dial 86 (country code) and 21 (city code) before the number.

PRC Labor Figures Show Dominant State Sector, Varying Wage Levels

At the end of 2000, China had 711.5 million workers, up 0.8 percent from the year before, according to the PRC Ministry of Labor and Social Security. Out of 112.6 million urban workers, 70 percent worked in the state-owned sector, 13 percent worked in collectives and 17 percent worked in the private and other sectors. The per capita annual income was ¥9,552 (\$1,154) for state workers, ¥6,262 (\$757) for employees in collectives, and ¥10,984 (\$1,327) for workers in private and foreign-funded businesses.

Individuals Jump Into the Housing Market

Individual buyers now dominate the housing market, accounting for more than 80 percent of all home purchases in 2000, according to China's *Financial News*. Individual home buyers account for more than 95 percent of all home buyers in Tianjin, Shanghai, and Chongqing. The resale of existing homes has also risen, as has the rate of home financing, with 80 percent of Shanghai home-buyers taking out mortgages. In Beijing, home mortgages to individuals totaled almost ¥41 billion (\$5 billion) in the first quarter of 2001, accounting for nearly 7 percent of all loans.

New Telephone Numbers in Zhejiang and Hainan Provinces

Telephone numbers in six cities in Zhejiang and Hainan provinces changed to 8 digits on May 18. Numbers reserved for special purposes such as emergency services or the government will remain the same.

Zhejiang Province

Hangzhou: Add 8 before numbers that start with 2, 5, 6, 7, 8

Ningbo: Add 8 before numbers that start with 6, 7, 8

Wenzhou: Add 8 before numbers that start with 6, 8

Hainan Province

Haikou: Add 6 before all numbers

Sanya: Add 8 before all numbers, area code changes to 898

Danzhou: Add 2 before all numbers, area code changes to 898

www.China

www.apecceo2001.org The official site of the 2001 Asia Pacific Economic Cooperation (APEC) CEO summit, to be held in Shanghai from October 18-20, features summit-related updates and information. Visitors can register for the event, make hotel reservations, and read up on tourist and travel information for Shanghai and China. The site has posted the program of event activities, including speakers and discussion topics, as well as a list of last year's events and attendees.

www.tda.gov The US Trade and Development Agency (TDA) helps US firms establish business operations in emerging economies through market research, technical assistance, and trade missions. The agency's website features an online library of feasibility studies, a small business consultant database, and a quarterly trade newsletter, all free of charge. Visitors can find background information on existing projects through a search engine or organized by region. TDA resumed work in China in January 2001 after a nearly 12-year, US government-imposed suspension of operations in the country.

www.stats.gov.cn/english The China Statistical Information Network, run by the PRC National Bureau of Statistics, contains a vast number of detailed and up-to-date PRC statistics. The website posts monthly economic data, the annual statistical communiqués of economic and social development, and the more detailed statistical yearbooks (though only the 1998 and 1999 editions are online). The website also includes an abstract of last year's national census, along with PRC statistics laws and a glossary. The Chinese version of the site also posts news articles and links to other statistical publications and websites.

www.mac.doc.gov/china/index.html China Gateway, under the US Department of Commerce's International Information Agency, directs visitors to free information about China's business environment. The site links to such government agencies as the Trade Information Center, which provides market information for China, and the US and Foreign Commercial Service, which provides consulting and advocacy within China. Visitors can find WTO impact studies along with copies of US-China trade agreements and related multilateral agreements. The China Compliance Hotline, run by the Trade Compliance Center, offers assistance to businesses that experience trade barrier problems.

<http://usinfo.state.gov/products/medreac.htm> This website, run by the US Department of State's Office of Research, quotes and summarizes foreign media editorials and op-ed commentaries daily. Collected articles address a different international policy issue each day. The site organizes articles according to country and usually includes selections from the Chinese press. The press sections of US embassies provide translations. Visitors may use the site and its 24-month archive free of charge.

www.asiajobsearch.org AsiaJobSearch, administered by the Institute of International Education and funded by the Freeman Foundation, is an employment service for Asian graduates of US universities who are looking for jobs with companies in East and Southeast Asia. Job seekers can post their resumé on the site or search for jobs by professional field or country, at no cost. Employers must pay a fee depending on how many jobs they post: \$1,000 for five jobs and \$3,000 for an unlimited number.

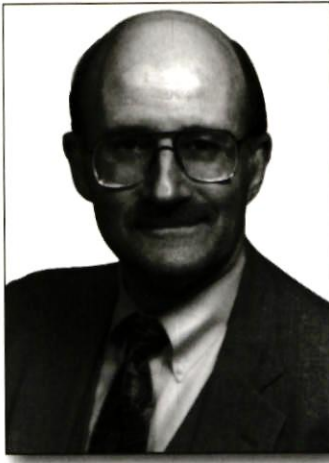
www.chinalaws.com Founded by a former PRC Supreme People's Court judge, China 1 Laws is a legal network offering free translations of many PRC laws and regulations. Visitors may view a wide range of laws and guidelines, including those relating to foreign investment, taxation, customs, labor, civil law, investment, and trade. The site charges for consulting and other services.

SITES IN CHINESE

www.scanweather.com The first broadband weather website in China offers weather updates and forecasts in print and streaming video free of charge. A collaboration between the Nanjing Telecommunications Bureau in Jiangsu Province and the Jiangsu Provincial Weather Bureau, this site features information on local, national, and international weather, including statistics, headline news, and space imaging.

www.china-infosec.org.cn China Net Information Security is a PRC government website that posts information related to computer and Internet security issues. Launched by the Ministry of Science and Technology and the Ministry of Public Security in January 2001, it includes Internet laws and policies, specification requirements, and links to computer- and security-related government agencies. This site also posts the latest virus news and alerts, hosts a chat room, and responds to e-mailed requests for assistance.

—Drake Weisert



Robert A. Kapp

To hear tell,
the Blue Hour
has arrived

LETTER from the President of the US-China Business Council

NTR 2001: To Sing the Blues or Walk the Walk

Like a bolt from the blue ... the "Blue Team," the truest case of David versus Goliath in the big-money world of Washington foreign-policy-making ... is posing the biggest-ever challenge to the generously funded China lobby of the Democratic and Republican establishments.... Unlike much of what they call the Red Team, which is blamed for putting business concerns above national security, Blue Teamers aren't in it for the money.... Today, the Blue Team no longer is merely a small group of individuals but a movement....

...China's April 1 interception and downing of a US Navy EP-3H [sic] intelligence plane in international airspace, its detaining of the 24 crew members and the continued impoundment [sic] of the aircraft have served to galvanize opinion among the American public, in Congress and within the Bush Administration around positions Blue Teamers long advocated...."

(Excerpted from J. Michael Waller, "Blue Team Takes on Red China," and "Blue Team Vindicated Time and Again," *InsightMag.com*, June 4, 2001.)

Yes, it's NTR time again.

China isn't in the World Trade Organization (WTO) yet, though it made a giant stride in that direction with the June 7 agreements between US Trade Representative Robert Zoellick and PRC Minister of Foreign Trade and Economic Cooperation Shi Guangsheng. Still, Permanent Normal Trade Relations (PNTR) is not yet the law of the land. And, in America, the law really is the law: no WTO, no PNTR. So we recline again into the steaming cauldron of a summer NTR debate.

Allow me to offer some thoughts on why it would be better for all of us if Congress decided not to overturn President George W. Bush's decision to renew plain-vanilla tariff treatment of China's imports to the United States for another year (or less, if China gets into the WTO before June 2002 and PNTR goes into effect as Congress intended) than if the United States were to shut down \$120 billion in trade with its fourth-ranked trade partner.

What follows can't match the flamboyance of the Men in Blue. It accuses no one of "kowtowing," "appeasing," or being a "paymaster" for the opposition.

I like to think that what follows pretty much embodies a case that the Congress has already broadly understood and accepted. Congress has, after all, sustained the presidential decision to keep the floor of our nation's engagement with

China in place every year for the past decade and passed the historic PNTR legislation one year ago.

1 The United States and China share a shrinking globe; each must maintain a firm commitment to strengthening the foundations of global stability. China and the United States continue to face opportunities and challenges in dealing with numerous regional and global concerns, from the questions before the upcoming Asia Pacific Economic Cooperation (APEC) meetings in Shanghai to the Korean Peninsula question, to issues of international cooperation in law enforcement and environmental affairs, among others. Neither country can wish the other away.

2 As China has increasingly entered the mainstream of world affairs since the end of the Mao era 25 years ago, it has become a major trading nation and a major trade and economic partner of the United States. It ranked seventh in the world in total trade volume last year. Total US-PRC merchandise trade last year exceeded \$120 billion. China is now the fourth-ranked US trade partner, and the United States is China's second-ranked trade partner. Since 1979, US firms have invested roughly \$30 billion.

3 Economic and commercial relations have been the most positive aspects of an often-troubled US-China relationship. Their continua-

tion is essential to the maintenance of orderly engagement and to the prevention of an ill-advised free fall in US-China affairs.

4 China and its WTO trade partners have resolved remaining issues standing in the way of China's full accession to the WTO. Because it will be some months before China's accession process is complete, under current law Congress must again consider whether to act as it has since 1981, by concurring with presidential renewal of standard US import tariffs for an additional year, or whether to do what it has *never* done through all the debates of the 1990s: overturn the action of the president of the United States in sustaining Normal Trade Relations with China.

5 Since 1992, the House has voted each year to sustain presidential renewal of NTR trade with China, on the grounds that NTR is merely the standard treatment the United States accords to all but a tiny handful of insignificant economies around the world, that the increasing economic interaction between the two nations is fundamentally in the US national interest, and that US repudiation of the massive trade relationship would hinder rather than help to address non-trade issues of concern to many members of Congress.

6 Congressional defense of normal trade status with China this year is in all likelihood a holding measure pending implementation of PNTR. Last year Congress, after a major debate, agreed that the full integration of China into the world's systems of economic and commercial rules and laws, through WTO, was in the best interests of the nation and the world economy. When China enters the WTO, perhaps by the end of 2001 or else probably in 2002, PNTR will become the Law of the Land, and annual congressional action on NTR renewal will cease.

7 President Bush has clearly pointed out that a productive relationship with China is desirable and possible and has pointed to trade and economic relations as an example of what is most positive about US-China relations today.

8 The United States and China have found it difficult to manage many non-trade problems in recent years. It would be immeasurably harder to control these issues if Congress were to succeed in overriding presidential renewal of NTR.

9 America's friends in the Pacific, including Japan and Taiwan, as well as the people of

the great free-market center of Hong Kong, strongly support continued stable economic relations between the United States and China; rejection of NTR would cause severe economic dislocation throughout the Asia Pacific region.

10 The fundamentals of the NTR question remain unchanged, in spite of recent flare-ups in the relationship:

- Trade and economic engagement with China generates American employment and contributes to business strength in the United States. China's continuing growth at 8 percent and its commitments to major new market-opening measures under WTO represent opportunity and stability for the US economy, particularly now, when the US economy is slowing. US exports to China rose 36 percent year-on-year in the first quarter of 2001.
- China's imports to the United States at ordinary tariff levels help to keep consumer goods affordable for all Americans, particularly those with low and moderate incomes.
- China's internal evolution in the direction of the market economy, WTO reforms, and the expansion of private enterprise remains on track, despite Chinese domestic worries that these reforms will provide too many opportunities for Americans and others at the expense of those in the PRC who benefit from China's current closed markets.
- China's economic relations with Taiwan, already massive, continue to expand heavily as the economic integration of the mainland and the island progresses. Taiwan's leader has stated his hope for continued normal economic relations between the United States and China.
- Shutting the market to tens of billions of dollars in Chinese exports to the United States will result in the closure of the Chinese market to US exports; the economic punishment of many ordinary workers in Chinese industries; the reduction of US employment supported by exports to China; the ceding of key strategic markets to US competitors in Asia and Europe; the stigmatization of political figures and others in China who are committed to the prime importance of a cooperative relationship with the United States; and very probably the comprehensive degradation of US-China relations, with unforeseeable consequences for both nations.

There it is: the case for NTR renewal, the case for a stable baseline in US-China relations. If the Blues want to call this "kowtowing to Beijing," so be it. I think the Congress will be more sensible than the Blues expect. 完

The fundamentals of the NTR question remain unchanged, in spite of recent flare-ups in the relationship.

Distribution in China: The End of the Beginning

Patrick Powers

With China's accession to the World Trade Organization (WTO) imminent, the Holy Grail of distribution and trading rights is almost within reach for foreign firms in China. Getting to this point has been neither easy nor inexpensive. Since the opening of China's markets in 1979, the history

China's WTO accession will mark a turning point in the development of China's distribution channels, but change will be more evolutionary than revolutionary

of distribution in China has been fraught with infrastructure problems and difficult legal issues, and many firms have been forced by those circumstances to use highly creative methods to bypass anachronistic and restrictive regulations in order to distribute their products.

Now that greater market access beckons, it is important for businesses to look back at the history of distribution in China to keep a sense of perspective about what changes new market-access opportunities will bring under the WTO regime. The underlying trend of the past 20 years is one of centrifugal force—as trading volume and opportunities have expanded, local and foreign firms have pushed the limits of existing trading regulations outward. This, in turn, has forced the government, directly or otherwise, gradually to liberalize the trade regime to reflect market conditions. From that perspective, accession to the WTO is simply the next evolutionary step in the reform and development of China's economy.

Distribution's Stone Age...

In the earliest days of China trade, professional distribution options were scarce. Maoist

doctrine encouraged each province and city to be self-reliant, resulting in considerable industrial overcapacity, few logistical synergies, and a vast bureaucracy. Foreign firms had little choice but to use state distribution networks, which were organized along rigid, vertical command-and-control lines. First-tier distributors were located in Beijing, Shanghai, and Tianjin municipalities, and Guangzhou, Guangdong Province; the second tier consisted of distributors in provincial capitals and medium-sized cities; and the third tier of distributors operated in smaller cities and towns. With no market forces at work, each level of the network passed products to state retailers and enterprises at their own level or to wholesalers at the next level, as instructed from above. Distributors essentially provided basic logistics services (transportation and warehousing) but no marketing support or sales reporting. Distributors were not allowed to import products; that right was reserved for foreign trade corporations (FTCs) in the major cities. Once an import entered the country, it was handed over to the appropriate distributor, as FTCs were forbidden to sell the goods downstream.

...and Middle Ages

As China's trade with the outside world grew, leaders recognized the need to liberalize this system. When the central government wants to liberalize or reform a particular policy, the most common practice is to implement the policy in measured, calculated steps—in order to evaluate what elements of the policy are and are not working at each step. As control during the 1980s continued to shift away from the center to the provinces and municipalities, which gained the right to establish their own trading companies, Beijing was satisfied enough with their progress to relax restrictions further.

By the late 1980s, domestic enterprises that met specified trade volumes were permitted to import and export directly. At roughly the same time, Beijing began to allow manufacturers to

Patrick Powers
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in Beijing.

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Distribution and the WTO: Some Historical Context

World Trade Organization (WTO) accession marks what may be remembered by historians as the end of modern China's economic beginning. For the leadership, giving foreign firms the right to operate freely in China is a very serious and sensitive matter that it discusses in a historical framework, specifically with reference to the preliberation period when foreign companies were dominant players in distribution (among other commercial sectors). Since 1979 China's leaders have dealt with this subject very cautiously and have now decided, perhaps reluctantly, that it is in China's best interests to allow significant foreign access to distribution and many other sectors. That is what the WTO is really all about from the PRC perspective—it is not so much about free trade as it is about the need to develop a professional financial and managerial culture based on internationally accepted commercial practices and rule of law so that the country can prosper in the years ahead.

—Patrick Powers

sell their own products directly to retailers, bypassing wholesalers entirely. Competition among state and provincial firms began to intensify, and as a consequence direct state control of imports began to break down. Legally ambiguous (“gray”) import channels sprang up, in many cases involving non-civilian work units, and an entire industry of these so-called “converters” began to emerge along a Hong Kong-Guangdong axis.

Further north, the central government decided to develop the Pudong area of Shanghai, beginning with a high-intensity propaganda blitz (similar to the current “Develop the West” campaign). Unfortunately the government's hopes of obtaining 70 percent of the development funding from foreign firms were quickly dashed, as Pudong had virtually no infrastructure and was an unattractive investment destination. Following the normal practice of using pilot programs to test policy options, the government's next attempt to attract investment was to allow local firms special trading privileges in Pudong. This was initially successful in attracting larger state firms, but still failed to generate significant actual foreign investment in the zone. The government's only logical option at that point was to try to create an export-processing area in what became the Waigaoqiao Free Trade Zone of Pudong. Foreign firms gained the right, under certain conditions, to transact business in domestic currency. This step, when combined with other incentives for professional services providers, kicked off a drive to develop Pudong into what it is today. Pudong's success is somewhat accidental; the government never intended it to be a center of *renminbi*-denominated sales into China. But as in many other instances, the central government was forced to accept commercial reality.

In the mid-1990s, as business volumes grew, foreign-invested enterprises (FIEs) increasingly despaired over prohibitions on sales of goods not manufactured in China and the problems involved in selling their products nationwide. Some of the key issues then (and now) included the inadequate state of transport infrastructure (despite progress in the past few years) made worse by monopolistic practices; a fragmented and chaotic distribution system; and local protectionism. Compounding these difficulties were (and still are) a general lack of professional third-party distribution channels; pricing issues; cash flow and accounts receivable problems; the high cost of building and maintaining distribution networks; and the usual petty bureaucratic interference frequently encountered in the PRC commercial environment.

Distribution's Enlightenment?

In spite of the difficulties of conducting one's own logistics and distribution activities in

China, companies can still earn a profit. In fact, contrary to popular belief, a majority of the foreign companies operating in the PRC are in the black, although perhaps not to the degree they would be if they were able to reduce costs by fully integrating their operations. In fact, many foreign firms have managed to set up national distribution channels and are well positioned to compete in a post-WTO China. Yet most of those same firms have to use a complex array of channels to fulfill their distribution needs and find it difficult to consolidate to take advantage of economies of scale. Nonetheless, the reality of the marketplace has been the greatest driver of change in distribution. A close look at what goods are available in the marketplace today both on the coast and inland reveals enormous changes compared to even five years ago. Regardless of the infrastructure and logistics problems, goods always seem to find their way to market.

One of the best examples of the change that has occurred in the distribution of goods in China over the past few years is the development of the hypermarket/big-box retail format since 1996, as exemplified by Wal-Mart Stores, Inc. of the United States, Metro AG of Germany, Carrefour SA of France, and China's own Shanghai Hualian Supermarket Co. and Lianhua Supermarket Co. Ltd. By virtue of their buying power, these local and foreign retailers have forced alteration of traditional distribution practices.

For example, the typical large foreign retailer will buy in one of two ways, often using sophisticated automatic order replenishment software: either through a third party that usually must provide a high level of service at low margins in exchange for high sales volume; or directly from the manufacturer, which will be pressured to offer the cheapest wholesale prices in the market. Given the high volumes involved, the retailers demand—and usually get—highly favorable payment terms, timely delivery, bar coding, and priority service, all of which were generally nonexistent just a few years ago. These demands have forced local manufacturers and distributors to upgrade their internal capabilities, especially in major urban areas, to the benefit of the distribution and logistics industry as a whole. It does not mean, however, that the old problems have disappeared; they still exist. The improvements to date are just from a relatively low base.

Aside from this trend, which benefits the consumer-goods sector, the different value-chain alternatives available to investors are fairly well established: local or foreign third-party distributors, representative sales/liason offices, joint-venture (JV) trading companies (on a very limited scale), and Waigaoqiao “exports” to the domestic market. One of the key questions for investors in China is how to consolidate sales, marketing, distribution, and back-office func-

tions across the breadth of their multiple operations. In many cases these ventures range from traditional JVs to wholly foreign-owned enterprises (WFOEs). Thus, larger firms have used one or more of the following structures: centralized sales organizations under a holding company; "service companies," in which an entity under an existing JV manages sales and market-

ing for all of the other group operations; or "sales-service JVs" (SSJVs), similar to "service companies," in which the SSJV acts as the agent and/or distributor of the FIE's other JVs.

Other options, although less conventional, are contractual (*chengbao*) and joint-operation (*lianying*) entities which enable the foreign party to act as a local company. Full details of these

The US-China Market-Access Agreement: Distribution Services

According to the November 1999 US-China Market-Access Agreement, as detailed in the White House Fact Sheet (www.uschina.org/public/wto/factsheets/distribution.html), China agreed to phase out current restrictions on access to distribution services within three years of accession. China made the following specific commitments in the area of distribution-related services:

● **Distribution of products made outside of China** In the first year after China's entry, foreign-invested companies may distribute products made in China and imported products.

● **Wholesale and commission agents services** Within one year of accession, foreign companies will be allowed to form joint ventures with no more than a 50 percent stake. Within two years foreign companies will be able to take majority equity stakes, and all geographic and quantitative restrictions will be eliminated. Within three years, wholly foreign-owned enterprises will be permitted.

● **Retail services** Upon accession, foreign service suppliers will be permitted to establish joint ventures in Zhengzhou, Henan Province, and Wuhan, Hubei Province.

Within one year of accession, foreign service suppliers will be permitted to establish two joint ventures in the five special economic zones (Shenzhen, Zhuhai, and Shantou in Guangdong Province; Xiamen, Fujian Province; and Hainan Island) and four cities (Dalian, Liaoning Province; Guangzhou, Guangdong Province; Qingdao, Shandong Province; and Tianjin). Four joint ventures will be permitted in Beijing and Shanghai, and two of the four in Beijing may set up branches.

Two years after accession, foreign companies will be able to own majority equity shares in these joint ventures, and joint ventures will be permitted in all provincial capitals and in Chongqing Municipality and Ningbo, Zhejiang Province. Within three years of accession, there will be no restrictions on equity, geographic areas, or on the number of service suppliers.

● **Franchising and sales away from a fixed location** Franchising, sales away from a fixed location (both wholesale and retail), and related activities will be permitted without restrictions three years after accession.

● **Exceptions** For retail department stores over 20,000 m³ and chain stores with more than 30 stores, China will only permit minority equity participation in joint ventures.

Excluded from China's commitments are wholesaling for salt and wholesaling and retailing for tobacco.

China will open markets more slowly in the areas identified below. China must still provide market access and national treatment without restrictions, but there are no intermediate "benchmark" commitments as for other products.

● **Chemical fertilizers:** China will allow foreigners to provide wholesale and retail services within five years of the date of accession.

● **Books, magazines, and newspapers:** China will allow foreigners to provide wholesale services three years after accession and retail services in five years.

● **Pharmaceutical products and pesticides:** Foreign companies will be able to provide wholesale and retail services within three years of accession.

● **Mulching film:** Foreign firms will be able to offer retail services one year after accession and wholesale services in three years.

● **Crude oil and processed petroleum products:** Foreigners will be able to provide wholesale services within five years of accession.

● **Processed petroleum products:** Retail services will be permitted within three years of accession. (Note: Crude oil is not excepted from China's retail commitment, so it will be treated as any other product.)

Services auxiliary to distribution

● **Maintenance and repair services** Foreign companies will be able to provide repair and maintenance services for household consumer goods, motorcycles, autos, and office machinery, including computers. They may establish joint ventures upon China's entry, hold majority equity shares in one year, and be free of restrictions within three years.

● **Technical testing and analysis, freight-inspection services** Foreign service suppliers that have been performing inspection services

in their home countries for more than three years and hold \$500,000 in registered capital may establish joint ventures upon accession, hold majority equity shares within two years, and be free of restrictions within four years. "Statutory inspection" services are excluded from freight-inspection services commitments.

● **Packaging services** Foreign service suppliers may establish joint ventures upon accession, hold majority equity shares within one year, and be free of restrictions within three.

● **Courier services** China's commitments cover land-based international courier services and all services related to international shipments handled by an express carrier. Foreign companies will be able to establish joint ventures upon accession, hold majority equity shares within one year, and be free of restrictions within four years.

● **Storage and warehousing services** Foreign firms will be able to establish joint ventures upon accession, hold majority equity shares within one year, and be free of restrictions within three years.

● **Freight transportation by rail and by road in trucks or cars**

● **Road transport:** Foreign service suppliers will be able to establish joint ventures upon accession, hold majority equity shares within one year, and be free of restrictions within three years.

● **Rail transport:** Foreign service suppliers will be able to establish joint ventures upon accession, hold majority equity shares within three years, and be free of all restrictions within six years.

● **Freight forwarding agency services** Foreign companies interested in operating in China should have at least three consecutive years of experience. They will be able to establish joint ventures upon accession and hold majority equity shares within one year. After one year of operation in China, a joint venture may set up a branch if it adds \$120,000 to the original registered capital for each branch established. All restrictions will be eliminated within four years. The minimum registered capital of a joint venture must be at least \$1 million and the length of operation must not exceed 20 years.

distribution alternatives can be found in the June 1998 US-China Business Council report, *Distribution of Goods in China: Regulatory Framework and Business Options*.

The future: WTO's limits

The question on every foreign investor's mind is, "What does the future hold under WTO?" First of all, it is important to remember that the full terms of the WTO services agreement are phased in over three years in most cases. Given the specific market-access commit-

Although state trading companies will fight hard to keep the status quo intact, WTO entry will almost certainly force them to become value-added service providers instead of the middlemen who make easy commissions today. They will have to upgrade their capabilities significantly in order to be attractive outsourcing candidates.

ments China has made regarding trading rights and distribution, foreign firms will immediately be able to distribute all products made in China as of the date of China's accession and will be able to distribute imported products a year later. For after-sales maintenance and repair, foreign service suppliers may establish themselves in China as joint ventures upon accession, hold a majority equity share in one year, and be free of restrictions in three years.

Just because China will be a WTO member does not mean that foreign firms will immediately set up their own exclusive distribution channels en masse. One major change that will occur soon after accession, though, is in the way state import-export corporations are used. Established firms will be able to bypass third parties in the value chain, generating significant savings in transaction expenses and related overheads. Therefore it is very likely that this will be an issue of primary importance in the short to medium term. Although state trading companies will fight hard to keep the status quo intact, WTO entry will almost certainly force them to become value-added service providers instead of the middlemen who make easy commissions today. They will have to upgrade their capabilities significantly in order to be attractive outsourcing candidates.

For the distribution industry as a whole, the more likely outcome will resemble the historical

pattern of evolutionary opening rather than immediate, revolutionary, change. Since both Chinese and foreign firms have the same logistics and distribution problems, they will exert significant competitive pressure on local distributors and service providers to improve their existing business models and force increased integration in the value chain. The result will probably be industry consolidation and introduction of more, and more-professional, service providers—the majority of which will likely be located in the provinces and may partner with others in neighboring regions. Nationwide, the larger foreign operators will also play a greater role, but they will only be able to benefit fully from WTO terms after three to four years.

The Chinese logistics industry is underdeveloped and historically prone to local protectionism, unfair competition, and an excessive number of government-related operators who enjoy the privileges of monopolistic regulations at either the national or provincial level. None of the ministries involved in different parts of the transport value chain, such as the Ministry of Railways or the Ministry of Communications, is renowned for its efforts to develop true intermodal capabilities within its own provincial networks, let alone nationwide. But as China enters the WTO, there will be a more pressing need to rectify that situation for the benefit of all concerned.

Leaders in the Chinese logistics industry believe that they have a three- to four-year window in which to restructure their firms and the industry before foreign operators become significant competitors. On the other hand, their customers would rather see the industry opened up as soon as possible, because history has shown that the earlier an industry opens up in China, the more it prospers; witness, for example, the strength of the consumer goods and household appliance markets in China today. These were the first markets opened significantly to foreign competition in the 1980s.

The caveat

Although the WTO will open up many markets in China, distribution and logistics, like other sectors, will no doubt experience implementation difficulties and delays. Foreign firms would do well to remember this fact as they attempt to broaden their distribution networks.

But anyone who visited China before 1990 will remember what China didn't have—which was just about everything in terms of business infrastructure and products. Today China has brought itself to the point (in many cases using foreign funds or technology) where, the usual litany of problems aside, the country has a strong foundation from which to develop into a modern economy. And this development will occur at an ever-increasing pace. 完

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Beyond Sinotrans: China's Distribution Infrastructure

Robert Gates

China National Foreign Trade Transportation (Group) Corp. (Sinotrans) comes closer than any other company in China to providing a comprehensive, national distribution service. Sinotrans is the nation's largest freight forwarder and boasts 3,000 trucks, 160 standard and refrigerated warehouses, 75 ships, 77 railway sidings, and 15 train-loading port terminals. The company has 47 domestic sub-

shipping company in China. It is dwarfed by the State Council-controlled China Ocean Shipping (Group) Co. (COSCO), which reportedly has nearly 500 vessels and is the seventh-largest shipping company in the world. In 1961, the government created COSCO to satisfy China's international marine shipping needs. In recent years, however, the company has become a major shipper between coastal and inland ports.

In 1994, COSCO began operating barge routes in the Pearl River delta out of its private terminal at the Port of Hong Kong, and now has 34 routes, 43 freight canvassing offices, and a total freight capacity of 2,252 20-foot equivalent units (TEUs) within the delta. COSCO also operates 170 container trucks for support and delivery. The company has similar operations along the Yangzi River, spanning the inland port of Chongqing to the port of Shanghai, where COSCO's trans-shipment hub transfers river barge cargo onto the company's ocean liners.

China's second-largest shipping company, China Shipping Co., also offers inland barge routes from Shanghai along the Yangzi. Founded in July 1997, the Shanghai-based company claims to be the fifteenth-largest shipping company in the world, consisting of over 340 vessels with an aggregate dead weight of 8.89 million metric tons. Its container fleet of more than 100 ships has a total capacity of 120,000 TEUs.

A look at the makeup of China's fleet of planes, trains, ships, and trucks

sidiaries and 263 domestic joint ventures. From its headquarters in Beijing, Sinotrans has attracted high-profile clients including Acer Inc., Panasonic, and Motorola Inc.

Every Sinotrans sales representative will tell you that the company can deliver a product to any location in China, including Hong Kong and Taiwan. And yet, despite the size of its vehicle fleet, the company has no planes of its own, a ship fleet a mere fraction of the size of China's largest shipping company, and a truck fleet only twice that of one of its Beijing trucking-service competitors. Sinotrans can cover the entire country through associations with PRC companies that provide services in each of the four roots of the distribution tree: water, rail, air, and road transport (*see* Table 1). With the exception of the road transport sector, these are controlled by either large, state-owned enterprises or government ministries.

1 Water transport

Shipping is China's most developed distribution sector. Chinese shipping companies rank among the world's largest and make calls in all of the world's major ports (*see* p.18).

Sinotrans, with its 75 ships and 35 international container lines, is only the third-largest

2 Rail transport

Rail is China's cheapest method of cargo transport—and for good reason. With inadequate network coverage and slow train speeds, rail transport from the port of Shanghai to far-off destinations in the northern provinces can take anywhere from 15 to 45 days, while deliveries to northeastern regions may take up to 60 days. Most logistics providers estimate that rail deliveries travel only 250 km per day.

Rail cargo transport falls under the monopoly of the Ministry of Railways (MOR). Though many companies, including Sinotrans and COSCO, offer limited rail service, all do so in

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conjunction with MOR. Characteristics typical of monopolies, such as high pricing for specialized services and a bureaucratic mentality, have led many manufacturers and distribution service providers to choose other forms of transport over rail.

HAVI Food Services, the worldwide distributor for McDonald's Corp., is a prime example. HAVI's task is an unenviable one: distributing to all 521 McDonald's restaurants in China. Train transport, with its fixed schedules and low prices, seems an ideal fit for HAVI. Indeed, the company's vice president and regional director for Greater China, William O'Brien, has been eyeing the rail sector for over seven years. For HAVI, O'Brien says, refrigerated and frozen transport capabilities are a necessity. In the past, the railways would refrigerate three or four connected train cars with one refrigeration unit and could not guarantee the even distribution of low temperatures throughout the cars. The large volume of the cars also made loading and unloading difficult and inefficient. In addition, poor maintenance of refrigeration units and inadequate handling facilities and warehouses (hardships not limited only to the rail sector) led to frequent breaks in the cold chain, ultimately endangering customers' health. Today, refrigerated rail container services are available on a limited scale. But, O'Brien says, "inexplicably high prices" have made them economically infeasible; thus, HAVI continues to use refrigerated truck fleets to distribute goods from its warehouses.

As companies continue to opt for other distribution methods, the current rail transport picture appears quite bleak. Fortunately, help is on the way. This year, MOR earmarked \$6.65 billion for investment in 21 construction projects to increase the rail network's current 38,000 km of track by 2,183 km and add 1,172 km and 2,824 km of double-track and electrified lines, respectively. Press reports also indicate that MOR plans to increase train speeds before the end of the year, as part of a long-term plan to raise the maximum speed of cargo trains to 120 km per hour over the next few years.

Perhaps most promising is the fact that World Trade Organization (WTO) accession will introduce competition into the rail cargo service sector for the first time. According to China's WTO agreements, foreign rail cargo transport providers will be able to establish joint ventures upon accession, hold a majority equity share within three years, and be free of all restrictions within six years.

3 Air transport

Most analysts predict that the air cargo sector will grow considerably over the long term. But high prices, an inadequate number of airports, and a small cargo transport capacity have limited

the sector's development so far. The Big Three airlines—China Southern Airlines Co. Ltd., China International Airlines Co. (Air China), and China Eastern Airlines Co. Ltd.—control 60 percent of the cargo market (see Table 2). Nevertheless, China Southern, the nation's largest passenger airline and the volume leader in cargo transport, does not own a single cargo plane, relying instead on the hulls of passenger flights to ship cargo.

Only three Chinese airlines have specially designated cargo planes, and only two of those—Air China Cargo and China Cargo Airlines Co. Ltd.—offer cargo services. (The third, China Postal Airlines, uses its three domestically manufactured Yun 8F100s for mail delivery.) Air China Cargo, the cargo transport department of Air China, has four Boeing 747-200s that are used for weekly flights from Shanghai and Bei-

World Trade Organization (WTO) accession will introduce competition into the rail cargo service sector for the first time.

Table 1
PRC Cargo Transport by Mode

Mode of Cargo Transport	Share of Total (%)
Water	53.3
Rail	32.2
Air	0.1
Road	14.4

SOURCE: Dezan Shira Market Research Ltd.

jing to New York City and Chicago, Illinois; Osaka, Japan; Frankfurt, Germany; and Hong Kong. Passenger flights carry domestic cargo traveling outside of the Beijing-Shanghai route to 53 mainland cities.

China Cargo Airlines is the country's first airline dedicated to cargo transport. Opened in August 1998 as a 70-30 joint venture between China Eastern Airlines and COSCO, China Cargo is headquartered in Shanghai and operates a fleet of three McDonnell Douglas 11Fs, which it owns, and a Boeing 747-200, which it wet leases from US-based Atlas Air, Inc. As the fourth Chinese airline authorized by the General Administration of Civil Aviation of China (CAAC) to conduct direct flights to the United States, China Cargo operates regular flights to

Table 2
China's Top Air Cargo Carriers (2000)

Airline	Cargo Carried (metric tons)
China Southern Airlines Co. Ltd.	438,899.9
China International Airlines Co. (Air China)	410,187.7
China Eastern Airlines Co. Ltd. (includes China Cargo)	348,068.2
China Southwest Airlines Co.	131,046.8
China Northern Airlines Co.	112,876.7

SOURCE: Sino Aviation News

As in the rail sector, the largest problem impeding the development of the air cargo sector is network coverage.

**Table 3
China's Top Airports by Cargo Transport (2000)**

Airport	Cargo Handled (metric tons)
Beijing Capital International	774,204.5
Shanghai Hongqiao	612,219.5
Guangzhou Baiyun International	491,868.1
Shanghai Pudong International	266,682.2
Shenzhen International	202,742.6
Hong Kong International	2,240,000.0

SOURCE: *Sino Aviation News*

New York City; Los Angeles, California; and Chicago, and is considering adding Seattle, Washington, as its fourth American point of entry in the near future, according to press reports.

In addition to its air routes, the cargo carrier currently operates 12 shipping routes of its own and manages parent China Eastern's cargo demands, which include 20 international and 120 domestic routes. The airline itself makes regular flights to Hong Kong and Nagoya, Japan, as well as non-scheduled charters to Osaka, Nagoya, and Okayama, Japan; and Seoul, South Korea.

As in the rail sector, the largest problem impeding the development of the air cargo sector is network coverage (see Table 3). *Sino Aviation News* reports that China currently has only 0.127 airports per 10,000 km², in comparison to 2.08 airports per 10,000 km² in many other reporting countries. To remedy the situation, CAAC Minister Liu Jianfeng said that under the Tenth Five-Year Plan (2001-05), airport construction will be a priority, and the airport network will be extended with the creation of smaller, regional airports. A three-tiered hub-and-spoke network is the ultimate goal, with major hubs in Beijing; Guangzhou, Guangdong Province; and Shanghai. Minor hubs will be built in Chengdu, Sichuan Province; Xi'an, Shaanxi Province; Wuhan, Hubei Province; Kunming, Yunnan Province; and Urumqi, Xinjiang Uygur Autonomous Region. Smaller, regional airports will be built in most of the other provinces (see *The CBR*, March-April 2001, p.18).

In the next 15 years, China plans to spend billions of *renminbi* on airport construction. According to *Sino Aviation News*, in the southwest, an area that accounts for one-fifth of China's land but currently handles only 8 percent of its air traffic, \$1.5 billion will be invested to raise the number of airports to 45 by 2015, 40 of which will be regional. In the northwest, \$906 million will go towards the construction of 10 new airports, bringing the total number in the region to 22 by 2015. More important, CAAC plans to make 80 percent of the airports in northwest China capable of operating in all weather conditions.

The largest project in CAAC's plan is the Guangzhou Baiyun International Airport which,

when finished in late 2003, will reportedly accommodate nearly 30 million passengers and 2.5 million metric tons of cargo. At an estimated cost of \$2.42 billion, the Guangzhou airport will compete with the world's leading cargo shipping hub, Hong Kong International Airport, which last year shipped over 2.24 million metric tons of cargo, the majority of which originated in the Pearl River delta.

4 Road transport

In late 2000, the Ministry of Communications (MOC) opened the Beijing-Shanghai expressway, supplying a sorely needed artery. Indeed, MOC plans to extend China's highway network in the next few years, with plans that parallel CAAC's plans for airport development. Last year, China reportedly spent \$26.6 billion on 50,000 km of



Photograph courtesy of Robert Gates

new highways, including 4,561 km of new expressways (which have higher speed limits and no intersections). MOC hopes that by 2005, China will have a total of 1.6 million km of highway, of which 25,000 km will be expressway.

The overall network, though, is still far from adequate. Until China's roads are both extensive and wide enough to support a nationwide trucking network and large tractor trailers, local fleets will continue to dominate the sector. The Sino-trans fleet of 3,000 trucks is the nation's largest, but it is only twice the size of Beijing City Transport Co. (BCTO), the capital's largest local trucking provider. Local providers literally drive the market, and most do so from behind the wheels of the omnipresent, dilapidated blue trucks that dot—and pollute—crowded urban streets.

A loose national network of local service providers exists among the reportedly 2.7 million trucking providers in China. Typically, large cities have several companies that provide trucks and drivers on demand as well as regularly scheduled routes and warehouse services. BCTO maintains a fleet of 1,203 trucks, most of which are small and therefore useful for making deliveries within

Beijing's Third Ring Road, an area with restricted trucking access during working hours. BCTO's largest trucks are 12 m long, and regularly make the roughly 14-hour run to Shanghai at a cost of ¥9.5 (\$1.15) per hour. The company claims to deliver anywhere in China at an average cost of ¥5.5 (\$0.66) per km. BCTO has working agreements with similar local trucking companies in other cities so that their trucks do not return empty. These agreements are the foundation of the loose national network.

Local providers are generally not very reliable. Their maintenance programs tend to be lax at best, and their warehouse facilities—if they have any—are typically inadequate. With few viable alternatives, though, many companies have had some success using a network of local fleets. HAVI uses its own trucks near central warehousing facilities and uses local distributors in outlying regions. To control costs and minimize the number of deliveries to each McDonald's restaurant, every HAVI truck—and every third-party truck—is capable of simultaneously handling goods at normal, cool, and frozen temperatures. Needless to say, truck maintenance is critical if food is to be kept fresh and safe for consumption. Holding local providers to a high standard is difficult, however. HAVI's O'Brien says that the key to working with local service providers is leverage. HAVI provides such a large amount of

business to its local service providers, like Sanxin Refrigerated Storage and Transport Co. Ltd. in northern China, that it has had great success in

Until China's roads are both extensive and wide enough to support a nationwide trucking network and large tractor trailers, local fleets will continue to dominate the sector.

convincing the companies to improve their maintenance routines and quality-control management (see p.24).

A more competitive industry

China's water, rail, air, and road infrastructure must improve before the country's distribution sector can expand. Sinotrans and its smaller competitors face a constant stream of logistical difficulties and are forced to rely on local providers. Nevertheless, with WTO accession nearing and more infrastructure developments planned, China's distribution sector seems to be headed for better days. As restrictions fall, competition will rise, prices will drop, and administration and management practices will sharpen, all of which will lead to a stronger distribution sector. 完

The Express Courier Market Shapes Up

A United Parcel Service (UPS) 747 landed in Shanghai Pudong International Airport on April 1, 2001—the company's first direct flight from the United States to China and a symbol of the growing competition in China's express courier market. Only five years after establishing its first joint venture in China, the American courier now operates six weekly US-China flights in support of its operations in 120 Chinese cities. Not to be left out, on that same April day express giant FedEx Corp. raised to 11 its number of weekly flights from the United States to China. With a 3 million package-per-day turnover, FedEx has operations in 210 Chinese cities and plans to expand into another 100 within five years. Already, the courier offers 24-hour door-to-door service from selected cities in China to 17 Asian cities.

Foreign competition is a serious threat to the state-owned domestic carriers that currently control China's express courier market. State Council-level China National Foreign Trade Transportation (Group) Corp. (Sinotrans) and China Post's Express Mail Service (EMS) together account for a majority share of the market, while the Ministry of Railways's China Railway Express (CRE) offers a smaller service that utilizes empty cargo space on MOR's passenger trains. EMS, though hampered by backward management, inefficient delivery opera-

tions (see *The CBR*, January-February 2001, p.61), and a bureaucratic mentality, manages to hold 70 percent of the domestic express delivery market through its parent China Post's vast delivery network and monopoly on express letter delivery services. In contrast, Sinotrans has maintained an impressive market share through modern operations and well-placed partnerships, primarily with Dutch courier DHL International Ltd. but also on a smaller scale with Dutch TNT Post Group, UPS, and Japan's Overseas Courier Service.

Current regulations limit foreign involvement in the domestic delivery market to minority holdings in joint ventures. DHL-Sinotrans Ltd. is unique in that its scope is national; most Sino-foreign joint ventures, even with the large domestic couriers, only serve local markets. Thus, foreign involvement in the courier market is largely relegated to international deliveries.

China's World Trade Organization (WTO) agreements, however, promise foreign firms full access to the domestic market four years after WTO accession. DHL secured itself a piece of the pie in 1996 by extending its contract with Sinotrans for another 50 years, and UPS CEO James Kelly recently said that UPS is also interested in China's domestic market.

—Robert Gates

A Sea Change

Iain McDaniels

Landlocked on three sides, China must route its marine traffic through ports stretched along its booming 18,000 km east coast, from Dalian, Liaoning Province, in the north to Beihai, Guangxi Zhuang Autonomous Region, in the south. Ports along China's major rivers, including the Yangzi (*Chang Jiang*), Yellow River (*Huang He*), Pearl River (*Zhu Jiang*), and

40 percent of all domestic and international cargo in 2000 (see Table 1).

Rolling down the river

China's major river ports have 8,528 berths, including 558 along the Yangzi. The Yangzi is China's longest and busiest river for shipping—most of China's top 10 interior river ports are located on the Yangzi (see Table 2). Shanghai, China's largest seaport, is located at the mouth of the Yangzi.

This year, China will invest ¥14 billion (\$1.7 billion) in inland water transportation, including infrastructure improvements, port equipment, advanced container ships, and high-technology cargo and vessel management systems. One of the country's major goals is to boost container traffic on the river network and create a container logistics network compatible with international intermodal standards and systems. One network will cover the Yangzi, with hubs at Chongqing; Nanjing, Jiangsu Province; Shanghai; and Wuhan, Hubei Province. The first international container port on the upper Yangzi opened in late 2000 in Chongqing. The Chongqing Jiulongpo Port cost \$26.5 million and has a capacity of 50,000 20-foot equivalent units (TEUs) per year. A second container network will be improved in the Pearl River, linking Guangzhou and Shenzhen in Guangdong Province with Hong Kong. Already, 55 river ports have some container capability.

Big boxes

China has embraced the move to container-based shipping. Between 1990 and 2000, the throughput of China's top 10 container ports increased 15-fold, from 1.2 million to 18.7 million TEUs. Altogether, China's major container ports handled over 22.7 million TEUs. Still, China's containerization rate is not very high; while container penetration rates are approximately 55 percent globally, today only a handful of China's ports are able to manage container traffic effectively.

Hong Kong continues to dominate in this area. According to a Hong Kong government study for the Hong Kong Port and Maritime

China's ports face changing industry conditions and the challenges of WTO

the Grand Canal, help move cargo from the coast to the interior. In total, China has over 1,200 ocean and river ports that offer berths for 33,000 ships, including more than 780 deep-water berths capable of handling 10,000-ton vessels.

China's ocean and river ports have struggled to expand in step with the country's massive trade growth over the past quarter century. For example, only 16 ports were open to foreign vessels in 1978; that number has grown to 130 today. In 2000, 2.35 billion metric tons of cargo moved through China's ports, with China's major ocean and river ports handling 1.64 billion metric tons, including 569 million metric tons of foreign trade cargo.

China's major ocean ports

The massive growth in China's trade with the world, which rose from \$20.6 billion in 1978 to \$474.3 billion in 2000, spurred rapid development and economic growth in China's major ocean port cities and the surrounding areas. Ocean shipping is also the most desirable way to ship goods from north to south for the domestic market, largely because of poor transport infrastructure on land. Much of this marine cargo volume is concentrated in a handful of ocean ports; indeed, China's top 10 ocean ports accounted for

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Board, Hong Kong's container throughput is expected to reach 30 million TEUs in 2010 and 40 million TEUs in 2020, up from 18.1 million TEUs in 2000.

Containerization of the industry will only grow, and most estimates expect China-bound container traffic to rise at least 20 percent per year over the next decade. Container volumes are expected to reach 40 million TEUs by 2005. The Hong Kong report projects that 70 percent of container traffic through Hong Kong will be from or to China by 2020.

Coming up short

Despite plans for expansion, shippers continue to face a host of infrastructure inadequacies:

- **Inefficiency** China's ports lack the ability to process and manage incoming cargo at international standards of efficiency. China's wharves average between 22 and 27 crane moves per hour, compared to 30 per hour in Hong Kong. The CSX World Terminal in Hong Kong can achieve speeds of 40 crane moves per hour.

China's ports lack the ability to process and manage incoming cargo at international standards of efficiency. China's wharves average between 22 and 27 crane moves per hour, compared to 30 per hour in Hong Kong. The CSX World Terminal in Hong Kong can achieve speeds of 40 crane moves per hour.

- **Bottlenecks** Companies passing goods through China's ports often encounter bottlenecks, especially between the port and other modes of transportation. Intermodal shipping connections often require at least two separate crane moves to get containers onto trains or trucks. China's overburdened and underdeveloped rail transportation sector in particular further impedes the smooth movement of goods.

China's Major Rivers and Ports



● **Cumbersome bureaucracies** Shippers must deal with a multitude of different bureaucracies to offload their cargo, including the local offices of the General Administration of Customs, the newly formed State Bureau of Quality Supervision, Inspection, and Quarantine, the State Administration of Foreign Exchange, and others. In addition, Customs clearance can usually only take place during business hours, and Customs officials will hold goods until any disputes over paperwork, duty rates, or valuation are settled.

● **Cargo losses** Pilferage and damage rates are higher in China than in Hong Kong and Singapore, according to industry analysts.

● **Infrastructure and capacity** China's busiest ports, including Shanghai and Shenzhen, are already operating at over 100 percent capacity—although many containers are being shipped in empty because of the cargo imbalance (see p.20). China's ports are not equipped for the next generation of larger cargo vessels and will have to undergo new construction and dredging to accommodate them.

● **Minimal foreign participation** Foreigners have only minority stakes in port facilities, with the exception of the 50.5 percent stake Hutchison Whampoa Ltd. has in the first two phases of the Yantian container terminal in Shenzhen that is currently under construction. Hutchison Whampoa has purchased 49 percent of Ningbo's Beilun container port and 30 percent of the container facility at Waigaoqiao Free Trade Zone, outside of Shanghai. Hutchison reportedly han-

dled 25 percent of all container throughput in China last year. P&O Nedlloyd took a 39 percent stake in the port facility in Qingdao, Shandong Province, and has committed to 20 percent of the second phase of the Shekou, Guangdong Province, facility. CSX maintains four berths in Tianjin. P&O Nedlloyd, Maersk-Sealand, and APL Ltd. currently may offer warehousing and other services to clients.

What China lacks in efficiency, however, it tries to make up for in cost. According to *Lloyd's List*, a maritime industry newsletter, terminal handling fees in Yantian and Shekou run about \$140 per 20-foot container and fees in Shanghai are only \$66 per container. Hong Kong, by comparison, charges approximately \$274 in handling fees for a 20-foot container.

WTO and China's ports

World Trade Organization (WTO) entry will have a direct impact on China's ports over time, first as ports get busier because of the uptick in trade, and later as shippers demand better service. Some Chinese ports already see themselves as competing with other ports in the region, not just with other ports in China. WTO entry will bring bigger trade flows, more intense competition, and a rise in foreign investment, all of which will lead to changes in the port sector.

Imports will likely rise dramatically as China cuts tariffs, eliminates quotas, and increases market access for foreign companies and their goods and services. Further, WTO entry will open overseas markets to Chinese products by removing certain quotas and restrictions on China's ex-

Table 1
China's Top Ports, 2000

Port	Metric Tons (millions)	% Change 1999	TEUs* (thousands)	% Change 1999	Number of Berths	Berths with Capacity >10,000 Tons
Shanghai	204.4	9.6	5,612	33.1	319	98
Ningbo, Zhejiang	115.5	19.5	902	50.0	285	32
Guangzhou, Guangdong	110.7	9.0	1,427	26.6	—	—
Qinhuangdao, Hebei	97.4	19.7	—	—	50	25
Tianjin	95.7	31.1	1,708	31.3	62	47
Dalian, Liaoning	90.9	6.9	1,008	37.0	69	39
Qingdao, Shandong	86.4	19.0	2,116	37.2	—	—
Shenzhen, Guangdong	56.8	21.9	3,993	33.8	—	—
Zhoushan, Zhejiang	33.3	54.9	—	—	—	—
Lianyungang, Jiangsu	27.1	34.0	—	—	60	25
Fuzhou, Fujian	—	—	400	25.8	—	—
Xiamen, Fujian	—	—	1,085	27.8	—	—
Zhongshan, Guangdong	30.1	—	458	15.3	159	9

NOTES:

* Twenty-foot equivalent units

— Not Available

SOURCES: Port authorities, *China Shipping News*, *China Business Times*, *China News Agency*, *Xinhua News Agency*, *China Transport News*

ports, leading to an increase in turnover. By 2005, WTO membership is expected to contribute to an increase in imports and exports of over 25 percent compared to a non-WTO China (see *The CBR*, March-April 2001, p.22).

WTO requirements on transparency combined with the government's ongoing anticorruption efforts should help close gray channels. This, in turn, should lead companies to select a port based on its economic and physical features, not based on personal connections or on tariff shopping, as is often the case today.

WTO entry will open China's ports to US service providers and bring service benefits for shippers and customers. The number of foreign agents will increase as foreign shipping companies become more involved in the local market. These companies will expect services in line with international standards, so ports will have to provide better service and efficiency. Ports will be forced to compete with one another based on services and infrastructure.

While the WTO Working Party has not yet completed negotiations on China's accession, the US-China bilateral WTO agreement signed in November 1999 gives a reasonably clear picture of China's market-access commitments in this area.

For instance, in addition to allowing the participation of foreign distribution and logistics companies, China has included a number of commitments under the General Agreement on Trade in Services for Maritime Shipping:

- **Shipping companies** Foreign firms will be able to take 49 percent stakes in joint ventures and will receive national treatment upon China's accession.

- **Shipping infrastructure** Foreign companies can participate in port development projects,

with limits, upon accession and will receive national treatment within three years.

- **Internal waterways** International freight shipping will only be allowed in ports open to foreign vessels.

- **Maritime cargo handling, Customs clearance services, container station and depot services, shipping inspection, and maritime agency services** Foreign-PRC joint ventures will be permitted upon accession.

- **Warehousing** China will permit minority joint ventures upon accession, foreign control one year after accession, and wholly foreign-owned ventures three years after accession.

Industry changes: Bigger ships, more boxes, better service

WTO entry has coincided with the consolidation of the Chinese shipping industry into a few groups of large shippers. Indeed, shipping companies have already ordered new, larger container ships to take advantage of economies of scale. Mega-sized ships, capable of carrying over 4,500 TEUs, are becoming more common on international routes; orders are already on the books for ships of over 7,000 TEUs. In fact, the 7,000-TEU *Shackleton* was recently christened in Shanghai, though the ship could only enter the river with less than a full load. These new ships put greater demands on port facilities and infrastructure. The greater draft of these vessels (45 feet or more) requires deeper channels and berths as well as larger gantry cranes to offload cargo stacked 17 containers wide or more. Many world-class ports are currently ordering cranes that can handle vessels 21 or 22 boxes wide. For efficiency, Chinese ports will need to acquire several gantry cranes per berth to deal with the

A Closer Look at the Shanghai Port

The Shanghai deepwater port project is the highest profile port infrastructure development proposed in China to date. Shanghai's port is currently reached through a shallow channel, only about 8.5 m deep, which prevents container ships of more than 50,000 metric tons (3,000 twenty-foot equivalent units [TEUs]) from entering Shanghai. The Huangpu River provides little room to maneuver.

The State Council has given its approval to begin construction on the first phase of the new port. The first phase, on Big Yangshan and Little Yangshan islands, 20 miles (32 km) off the coast, would be completed by 2005 at a cost of ¥15 billion (\$1.2 billion). The plan calls for the creation of five container berths each about 15 m deep—capable of accommodating fifth- and sixth-generation con-

tainer ships. A 20-mile, four-lane bridge will be built to move cargo from the deepwater port to Shanghai and beyond. When completed sometime around 2020, the port will have 50 deepwater berths and be able to handle 20 million TEUs yearly.

To get the most out of Shanghai's current port operations, meanwhile, the Shanghai government is carrying out a multiphase dredging program. Phase one will dredge down to a depth of roughly 9 m, allowing 3,000-TEU vessels at high tide; phase two plans to dredge down to about 13 m for 4,000-TEU ships, although there are questions about the feasibility of maintaining this depth.

—Iain McDaniels

Table 2
China's Top Inland River Ports, 2000

Port	Metric Tons (millions)
Nanjing, Jiangsu	66.79
Nantong, Jiangsu	26.30
Hangzhou, Zhejiang	21.81
Zhenjiang, Jiangsu	21.50
Zhangjiagang, Jiangsu	19.94
Wuhan, Hubei	17.34
Changzhou, Jiangsu	10.85
Wuhu, Anhui	8.17
Chongqing	7.81
Changshu, Jiangsu	7.85

SOURCES: Port authorities, *China Shipping News*, *China Business Times*, *China News Agency*, *Xinhua News Agency*, *China Transport News*

At a WTO-related conference on China's port development, port operators were urged to improve the quality of their services by completing ISO 9000 series quality certification, implementing education and training programs, and learning from international distribution and logistics practices.

large volume of cargo offloaded at one time.

In recognition of the demands on port facilities that WTO entry will impose, China's government is urging ports to upgrade both infrastructure and services. The goal of China's Tenth Five-Year Plan (10th FYP, 2001-05) is to use government and foreign investment, combined with central planning, to improve efficiency in China's port infrastructure. During the Ninth FYP (1996-2000), China invested ¥42.1 billion (\$5.1 billion) in coastal ports and ¥23.1 billion (\$2.8 billion) in internal waterways, which led to 96 new deepwater berths and 340 new river berths. The 10th FYP builds on this development, calling for China to develop important regional ports and small and medium-sized local ports, improve waterway conditions, accelerate large-scale harbor

and container berth construction, increase the number of deepwater berths, and purchase port equipment. During this period, China will build 135 deepwater berths and rebuild 45 old ones, adding 250 million tons and 16.5 million TEUs to China's handling capacity. Container ports will be developed and expanded in Dalian, Ningbo, Qingdao, Shanghai, Shenzhen, and Tianjin. By 2005, the government projects total capacity will reach 1.43 billion metric tons.

The ports reportedly see their greatest weakness as "software," especially industry knowledge and human resources. On the service side, ports are being asked to improve their software through a series of programs. At a WTO-related conference on China's port development, port operators were urged to improve the quality of their services by completing ISO 9000 series quality certification, implementing education and training programs, and learning from international distribution and logistics practices. Demands for better service and greater efficiency are leading to greater reliance on high-technology information systems to provide up-to-the-minute information on container location, as well as smart use of terminal resources. Some foreign-invested container ports in China are already using world-class information technology systems.

In early 2001, Customs made public plans for developing a "China e-Port." China e-Port is a complex web linking government agencies, banks, ports, shippers, and customers. China e-Port will link the intranets of Customs, the Public Security Bureau, the State Administration for Industry and Commerce, the State Administration of Taxation, and the State Bureau of Quality Supervision, Inspection, and Quarantine with banks and real-time cargo information from China's ports. The goal of China e-Port is to improve efficiency and transparency, close loopholes, and facilitate electronic shipping documentation. The system will allow enterprises to handle online both foreign exchange settlement for exports and customs documentation for imports. The China e-Port system is being piloted now in key ports and is expected to be fully operational by the end of 2001.

Setting sail

Changes in the shipping industry in China and worldwide will keep China's planners and port operators busy in the years to come, not to mention the increase in trade flows from China's pending WTO entry. Though China is making the infrastructure investments necessary to prepare for the increased throughput the country will face in coming years, the efficiency of the port system will be biggest obstacle to global competitiveness. 完



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Dry Packaged Goods: Overcoming Logistical Hurdles

Ainsley Mann

Chinese service providers are more open than ever to adapting to the needs of goods suppliers

Sit a group of logistics service providers down in a room together and ask them who is interested in moving goods between Shanghai and Guangzhou, Guangdong Province, and you will see them all raise their hands. Ask the same group who is interested in

moving goods between Hefei and Bengbu in Anhui Province, and the response will be much less enthusiastic. Therein lies one of the major problems facing the packaged-goods industry in China—how to move product into China's vast hinterland in an efficient and reliable manner. This is known as the “primary” distribution issue.

Sit a group of packaged-goods companies down in a room together and ask them to name their major distribution issue, and most will refer to problems controlling distribution at the retail or outlet level. Without such control, companies face an uphill battle managing pricing structures and territorial distribution agreements. They also cannot understand true demand levels or adequately influence availability and merchandising at the point of sale. Therein lies the next major problem—how to control distribution by eliminating various wholesale tiers without vastly inflating the cost structure. This is called the “secondary” distribution issue.

Companies have found that embracing current systems, which rely on local service providers in China, rather than excluding them from their strategies is key to resolving these two major issues.

Primary transportation

Moving goods within China by rail or ship (both along the coast and inland) is cheaper than moving them by road. However, most customers, whether wholesalers or retailers, lack a physical presence at either a rail station depot or inside a port. Furthermore, rail and shipping schedules have yet to offer the frequency and flexibility of road transportation. As a result, most packaged-goods manufacturers must move their products by road for either all or part of the journey.

Today, the road transport industry in China is extremely fragmented and dominated by a small number of strong regional and provincial players, as well as by an eclectic mix of local entrepreneurs and local government-affiliated providers. Generally, and particularly at the local level, the industry suffers from pricing cartels, fleets composed of inefficient and inappropriate equipment, lack of financing for equipment upgrades and technology investments, poor backhaul (return) fill rates, overloading, poor service, incorrectly registered fleets, and an “if it ain't broke, don't fix it” mentality toward preventive maintenance.

At the legislative level, the industry is overregulated but underenforced, resulting in rampant violation of vehicle registration and loading requirements. From time to time, provincial governments conduct arbitrary crackdowns on these practices, often resulting in chaos within the industry. During a crackdown in Fujian Province last year, for instance, most trucking companies took their vehicles off the road until the crackdown ended and enforcement relaxed.

Foreign logistics companies have made tentative steps to enter the market but to date really only operate between major cities. They struggle to compete on price, cannot offer nationwide service, and often must subcontract to local operators—all factors that combine to make their “value-added” proposition a tough sell (see Figure 1). Foreign operators claim, however, that by

Ainsley Mann

is group manager, Logistics & Planning, Swire Beverages. Swire Beverages is a Coca-Cola Co. anchor bottler with nine operations in mainland China as well as operations in Hong Kong, Taiwan, and the United States. This article reflects the views of the author, not necessarily those of Swire Beverages.

taking a more active role in a client's supply-chain management, among other tactics, they can help lower supply-chain costs by reducing inventory levels. Though their assertion may be true to a certain extent, one of the key drivers of supply-chain inefficiency in China—the lack of transparency caused by wholesaler dominance of the distribution channels—is largely outside the control of foreign logistics companies.

Costs

Figure 1 shows a pricing index for various categories of transport provider based on a study conducted in September 2000. A high-volume dry-goods distributor using a regional or local service provider can expect costs of between ¥0.38 (\$0.046) and ¥0.45 (\$0.054) per metric ton km (the cost of shipping one metric ton of goods one kilometer) before volume discounts, back-haul rebates, and other incentives. In the low-margin packaged-goods business, these low costs are hard to ignore. The trick is reaping the cost benefits without sacrificing service and quality.

Working with the locals

Foreign packaged-goods manufacturers in China often belittle local haulage contractors for poor service, incompetence, and lack of foresight. Anyone who has worked in a joint-venture or a startup environment has probably seen the least-qualified staff allocated to the transport and warehousing functions while production, finance, and sales get the pick of the crop. Little wonder, therefore, that logistics development has lagged behind other areas until very recently. Though it is true that there is room for massive improvement in the logistics sector, it is also true that these companies have for a long time merely been responding to a local market that wanted the lowest-cost solution at the expense of most other requirements. Under such market conditions contractors had little rationale to upgrade equipment and improve service. The concept of developing business relationships built on “win-win” situations for both sides did not really exist. But if other industries in China can replicate products and best practices from elsewhere in the world, why not the local transport industry?

Given the lack of either nationwide or foreign-managed logistics provider options and that the overwhelming majority of competitors in the packaged-goods industry in China are local companies that use the lowest-cost transport provider, companies must often develop strategic relationships with local service providers to maintain a competitive cost structure. Besides, bringing in an outside contractor and excluding the existing local contractors often requires severing long-term relationships, which may result in operational difficulties and unnecessary hostility.

The need for education

If the distribution industry is to improve, all the key stakeholders—including transport providers and goods suppliers—must learn the benefits of developing closer working relationships. Issues they need to address include:

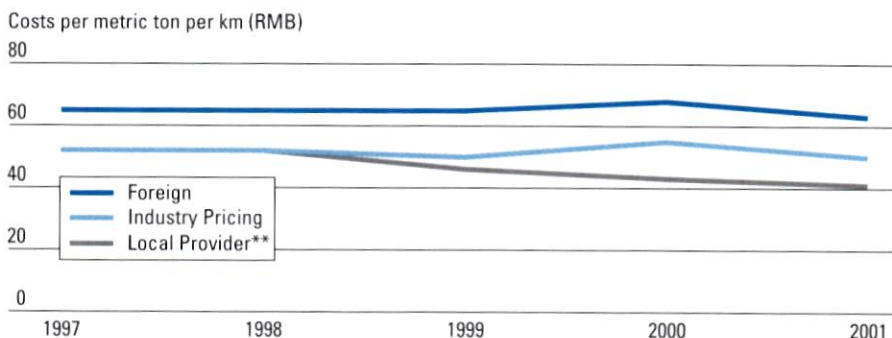
Particularly at the local level, the industry suffers from pricing cartels, fleets comprised of inefficient and inappropriate equipment, lack of financing for equipment upgrades and technology investments, poor back-haul (return) fill rates, overloading, poor service, incorrectly registered fleets, and an “if it ain’t broke, don’t fix it” mentality toward preventive maintenance.

● **Productivity of both assets and drivers, and the financial impact of improving both** Transporters and goods suppliers must focus on scheduling and streamlining material handling to move more volume per vehicle per day.

● **More efficient material handling** Firms must assess the impact on productivity and product damage of moving away from time-consuming hand loading and unloading of individual cases to loading and unloading of full pallets.

● **Better planning to avoid base cost increases resulting from fuel price increases or proposed changes in legislation** Companies should conduct lifetime cost analyses of different vehicles to assess the impact of such changes.

**Figure 1
Transportation Rates***



NOTES:

*Spot rates on the local market

**A local provider is a service provider that has become a strategic partner.

SOURCE: Ainsley Mann

● **Better understanding of wider supply-chain costs associated with low-cost but poor-quality transportation operations** Transporters and goods producers should assess the impact on gross contribution resulting from the loss of sales associated with a late delivery.

If the distribution industry is to improve, all the key stakeholders—including transport providers and goods suppliers—must learn the benefits of developing closer working relationships.

● **The need to set measurable objectives (key performance indicators [KPIs])** All contracts now have performance-related penalties and bonuses based on a series of KPIs that help managers better quantify the cost and benefits of identically priced contractors.

● **The need for basic finance skills** Companies should train transport managers to understand the impact of productivity on cost structures and how to reduce rates while maintaining margins.

● **The need for asset-management skills** Transport firms should focus on avoiding costly and unplanned maintenance by carefully scheduling both preventive and predictive maintenance.

● **Better management of controllable and variable costs** Both sides should assist line managers to understand exactly how their decisions contribute to overall costs so that they will make cost-saving decisions.

Once the joint education process begins, participants can clearly see which local providers appreciate the need for change in both the relationship and operational practices. Entering into such a dialogue will make both sides aware of the low-hanging fruit that can be exploited for their

mutual benefit. The process should begin with a consensus on existing cost structures, then pass through a joint analysis phase that results in a joint business plan. This plan, in turn, should form the foundation of an operational contract. In order to achieve this result, all layers of management from both sides need to be engaged in the process.

Most companies that have participated in such a dialogue find that their year-on-year costs fall. The service providers move from a loss-making situation to a break-even situation or better, increase the productivity of their assets by over 50 percent, standardize material and operations processes, and win significantly more business in terms of volume.

For most service providers, the difference between breaking even and making a profit is the amount of back-haul revenue. As part of the education process, service providers should learn that in return for regular volumes their back-haul rates should improve without adversely affecting productivity targets. The manufacturer can often greatly assist in securing back haul from key accounts, contacts, and suppliers. Contracts should specify how to split the benefits of this additional revenue.

Trucking equipment

The overwhelming majority of local transport companies is saddled with outdated, inappropriate, and inefficient equipment. The industry is currently at a crisis point: the contractors are operating at a loss, and their major customers are unwilling to agree to higher rates because of stagnating prices for goods nationwide. This standoff cannot continue without casualties.

Research conducted with a number of transport companies and vehicle suppliers clearly shows that correctly registered, imported tractor units fitted with locally produced, curtain-sided trailers can still operate more cheaply than vehicles that are 100 percent locally sourced (see Table). Costs shown are based on 11,000 km per month per vehicle and exclude any general and administration overhead, but do include financing charges, tolls, and other operational costs. According to *China Automotive News*, over the last 10 years the market for heavy-duty trucks has doubled while the market for medium-duty trucks has receded by 50 percent. The only surprising point about this statistic is that the change has not been more marked given the clear cost advantages.

To date none of the major international truck manufacturers, such as Volvo Group, Scania AB, and Hino Motors, Ltd., has established a manufacturing base in China, although Isuzu Motors, Ltd., which has been manufacturing light trucks in China since the 1980s, recently announced separate plans to manufacture heavy-duty trucks. The result has been that local transport companies have had poor access to better equip-

Cost per Metric Ton for Various Truck Types

Truck Type	Registered Load (Tons)	Payload (Tons)	Cost per Metric Ton per km (RMB)
Imported Tractor and Local Curtain-Sided Trailer	30	26	0.21
Local Tractor and Trailer	15	22	0.24
Local Medium Duty Vehicle	5-8	12	0.35

NOTE: Registered load is the weight of the vehicle as listed on the license documentation. Payload is the weight of the merchandise being shipped.

SOURCE: Ainsley Mann

ment. Some manufacturers, like Volvo, have entered into innovative financing and maintenance packages to ease the initial financial impact of, and local service providers' concerns about, imported equipment, and a number of contractors have taken advantage of such packages. But local contractors are unlikely to make investments without contractual and operational support from their major customers, such as some form of nonexclusive contractual obligation for a minimum period of, say, two years. In most cases, they are more than willing to change the composition of their fleet once they have seen the business rationale for doing so and once they are convinced of their customers' support.

Until major national players emerge, packaged-goods manufacturers will still have to work with local transport providers. The difference today compared to a few years ago is that manufacturers have opportunities to work with these providers to mold them into a form that can be more closely aligned with the needs of the packaged-goods industry. However, doing so requires effort on the part of all parties, including equipment suppliers.

Secondary distribution

Value-chain management normally refers to the flow of information and cash from the consumer or customer back up the value chain to the raw material supplier, and then the flow of goods in the reverse direction. Business executives are finding numerous new opportunities to create value for both suppliers and customers through collaboration facilitated by new technology, such as enterprise-wide visibility of demand and inventory. "Customer relationship management" has become a mantra for many sales and marketing directors. That's all very well if you know who your customers are, but the reality in China is that most packaged-goods companies do not (see Figure 2).

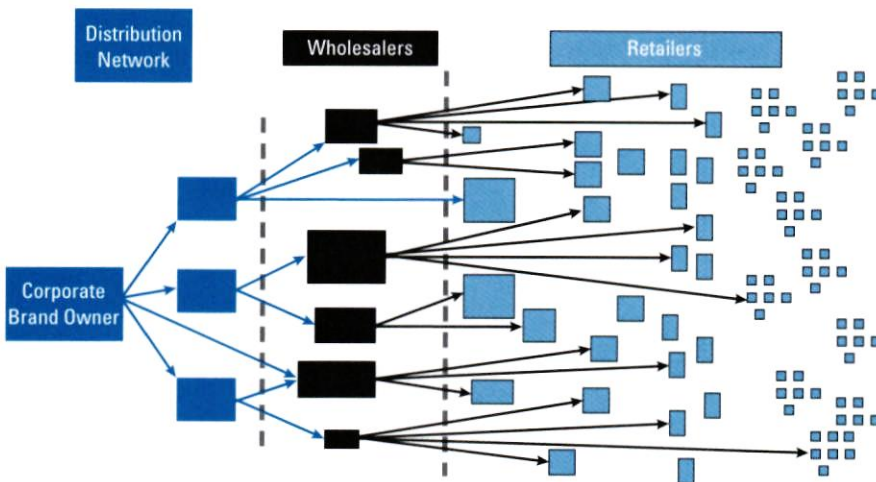
Wholesalers—good or evil?

Some wholesalers actively share information with their suppliers. At the other end of the spectrum, other wholesalers perform merely a cash collection function. From a logistics perspective, however, the wholesale system in China collectively performs a valuable service role that most packaged-goods companies could only dream about replicating in-house.

Consider that China has an estimated 12 to 16 million retail outlets and that the vast majority are independent, family-run stores that are not aligned to any major cooperative support via the likes of Independent Grocers Alliance, known worldwide by its abbreviation "IGA." The hand-to-mouth existence of each of these stores requires the minimum amount of inventory, which for the quickest-moving packaged goods could be the equivalent of one or two days' stock. The task of servicing this vast retail universe has

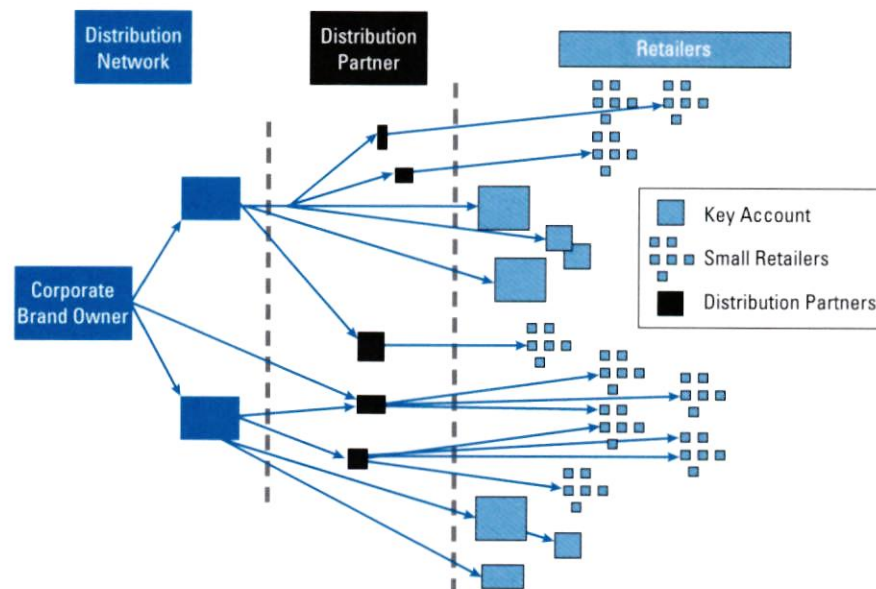
The wholesale system in China collectively performs a valuable service role that most packaged-goods companies could only dream about replicating in-house.

Figure 2
China's Physical Distribution Structure



NOTES: In this structure, corporate brand owners lack control over their brands at the retail level. Blue arrows indicate relationships in which the brand owner is visible to the retailer, and vice versa. Black arrows indicate relationships in which the brand owner is not visible to the retailer, and vice versa. SOURCE: Ainsley Mann

Figure 3
An Alternative Physical Distribution Structure



NOTES: The brand owner executes a more controlled distribution strategy by carefully selecting a few large accounts to service directly and allocating the remaining small accounts to distribution partners to provide delivery. Blue arrows indicate relationships in which the brand owner is visible to the retailer, and vice versa. SOURCE: Ainsley Mann



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resulted in the multi-tiered wholesale network that exists today. Some packaged-goods companies have attempted with various degrees of success to service the retail outlets in the major cities directly, but not one has done so throughout the rest of the country, where much of the volume growth opportunity lies. For most companies, the trade-off between the benefits of direct relationships with retailers and the costs of providing the minimum drop size and delivery frequency required to replicate traditional service levels has not been justified.

The real keys behind the success of this network from a service perspective are the second- and third-tier wholesalers who provide retailers with delivery service. Coincidentally, these are the same wholesalers whose margins are being squeezed by the primary wholesalers and retailers. Many operate at margins of 1 or 2 percent. They also invariably receive few if any of the benefits of the pricing discounts that primary wholesalers negotiate from suppliers on a regular basis. If the brand is strong enough, most of this bottom tier of wholesalers and distributors appear willing to change their business model to work with the brand owner directly.

Distribution partnerships

Companies will find that using distribution partnerships throughout their operations can help them develop retail relationships without increasing costs. The basic premise behind the strategy is that some wholesalers at the local level are both willing and able to perform a frequent and reliable delivery function not just inexpensively but, most important, transparently. Such distribution relationships transform these wholesalers into local delivery service providers that deliver goods at a pre-agreed cost per case upon transfer of an order from a company salesman. Provided the brand owner can still exercise control over the retail interface through regularly scheduled visits, the brand owner can make significant strides toward achieving the universal goal of controlled distribution at a competitive cost (see Figure 3).

Obviously, physical distribution costs may increase as a result of servicing the distribution partners instead of the much larger primary wholesalers, but this extra cost is more than off-

set by the increase in margin retained from eliminating one or two layers of wholesalers. It is certainly far more financially palatable than filling orders directly to the retail outlet using in-house assets. Also, companies can roll out this model significantly more quickly than they can bring everything in-house.

Companies will find that using distribution partnerships throughout their operations can help them develop retail relationships without increasing costs.

While recognizing that this model requires a relatively strong brand name and high volumes to prove successful, lesser-known brands would do well to consider it. Indeed, complementary brands may choose to work together in order to share economies of scale and present a more attractive proposition to potential distribution partners.

In for the long haul

China is just too big for a company to do everything itself. Waiting for someone else to come along with a cradle-to-grave, silver-bullet solution for distribution problems is unrealistic.

Local companies and distribution structures have, in their own ways, performed important roles in getting packaged goods to market in a reasonably efficient and cost-effective manner. However, the prevailing *modi operandi* are not necessarily suited to resolving the challenges that most packaged goods companies want to address.

In the same way that many foreign-owned packaged-goods companies are waking up to the fact that they need to modify their preferred strategy of using foreign logistics providers and eliminating wholesalers, so China's transportation and distribution industry has become much more open to modifying the way it operates. The result is a tremendous opportunity to work with what is available in China to solve these fundamental issues. 完

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Starcon Corp. Finds Its Way

Sean Huang

Starcon Corp., founded in the United States in 1979 as a real estate management and development company, has evolved into a company operating primarily in China's distribution sector. We are currently developing a national distribution and sales network for consumer products in China that will help manufacturers reach their end consumers via the appropriate retail channels. We operate in China primarily through a joint venture with the

A small US company discovers a distribution niche in China's retail market

China Academy of Traditional Chinese Medicine. We also have a representative office in Beijing and plan to establish a wholly foreign-owned enterprise. We had annual revenue of nearly \$1 million in 2000 and employ about 50 people—mostly in Beijing, with some regional staff elsewhere in China and two employees in San Jose, California. We have thus far managed sales and distribution in 16 major Chinese cities.

Our current business, while promising, is not the one in which we started out in China. During our first few years in the country, we evolved from a small business selling a single product into a growing company in the promising field of product distribution. We now sell our own brand of nutritional supplements and also distribute a major US brand of nutritional and food supplements. With our sales channels established in supermarkets, department stores, and pharmacies, we are working to expand into other product lines that use similar channels and are currently negotiating with several US packaged-food manufacturers.

and market Chinese medical products. The joint-venture agreement called for Starcon, which was the majority shareholder, to contribute cash. The academy provided personnel, office space, and new products. The investment for both sides was small, a total of \$250,000, and for Starcon this was a low-risk opportunity to get its feet wet in the promising Chinese market.

Initially, Starcon maintained control of the board of directors while the academy managed the day-to-day operations. During this period, which lasted for over a year, the joint venture barely managed to survive as local managers misspent and embezzled much of its money. Worse, the joint venture lacked a clear business plan, and the academy produced unsaleable goods. Our sole source of revenue was door-to-door sales of acupressure kits.

From its US headquarters in San Jose, Starcon looked for related products to sell in China around which it could build a more solid business. We considered selling pharmaceuticals, medical equipment, or nutritional supplements to the mass market. Strong competition, our lack of relevant expertise, and a prohibitive regulatory environment eliminated the medical field from consideration. Because the regulatory environment for nutritional supplements, though still a barrier to entry, was less daunting than that of medical products, we decided to market nutritional supplements. Perhaps more in our favor was the fact that there were no strong competitors—existing players were mostly local companies without long-term aspirations. Also, the necessary expertise for this field, including product knowledge and staff with the necessary credentials, was readily accessible through our partner and Starcon's own personnel.

After we identified and secured our first product (a nutritional supplement that we still import to China), we began to reorganize the operation. With the academy's agreement, we replaced the general manager that it had appointed. The joint venture secured an import-export license, rare among foreign enterprises, through the help of its staff's high-level government contacts. This license has helped us eliminate many of the logistical concerns that plague

Sean Huang

is managing director of Starcon Corp. (www.starconcorp.com) in Beijing.

A rough entry

Starcon has been in business in China for over five years. In 1996, we formed a joint venture—Beijing Jontarcon Co.—to manufacture

other businesses. Our staff also worked diligently to register our product for sale in China, a difficult and time-consuming process. Two years after founding the joint venture, we had a product to sell and were prepared to sell it.

A new strategy

To launch our product, the joint venture had to decide whether to work with regional distributors or to build its own distribution system, starting with Beijing. While most companies in the nutritional supplement industry would probably have chosen the first option because it promised the quickest delivery to store shelves, we decided to go it alone. We were concerned that we lacked the experience needed to manage a national sales network and that regional distributors would provide an inadequate level of service. More important, our product had yet to be recognized in the marketplace. As a result, we would have been unable to secure cash terms for the product, exposing the company to considerable credit risks. Many producers in China provide generous credit terms to distributors for the first shipment—which is often provided for free as a means to get product onto store shelves—but expect cash for all subsequent shipments.

We dove headlong into the business, investing in local advertising while establishing a base of retailers in Beijing. We selected about 100 of the

biggest and most upscale pharmacies and department stores to carry our product. The fact that Chinese retailers sell most of their inventory on consignment facilitated the establishment of retail accounts. This strained our resources, however, as banks in China generally prefer to provide asset-based lending. Starcon provided the funds for the inventory privately and sold to the joint venture on consignment terms.

Problems arose quickly. We failed to conduct any market research before launching our advertising campaign and ran a series of unrelated advertisements in newspapers, magazines, subway systems, and radio hoping to stumble onto an unidentified target audience. As a result, much of the advertising was ineffective. To complicate matters, we had trouble collecting our relatively small accounts receivable from opportunistic retailers who correctly perceived that our sales personnel and procedures were inadequate to enforce collection. The comprehensive nature of these problems suggested shortcomings in the local management team.

Starcon steps in

Recognizing that the venture in China was in jeopardy, Starcon finally realized that it had to become directly involved in operations. Starcon assigned permanent staff from the United States to direct the joint venture's business. This was effective

We had trouble collecting our relatively small accounts receivable from opportunistic retailers who correctly perceived that our sales personnel and procedures were inadequate to enforce collection.

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tive because it not only gave Starcon day-to-day control of the business but it demonstrated to the local staff that Starcon was willing to dedicate resources to the joint venture and that it had confidence in the overall direction of the business.

We urgently worked to correct the flaws within our operations. We made the difficult decision to replace much of the staff, including most of the managers, since retraining personnel would be too time-consuming and costly.

With able managers at sales sites, we have been able to project a good product image and maintain productive relations with our distributors and key retail accounts, while identifying other potential distributors for additional products in the future.

We also identified new and cost-effective marketing opportunities while streamlining existing advertising programs. Rather than relying on expensive mass advertising, we focused efforts on points of sale (POS) by securing staffed counters at key retail locations so we could directly speak with and sell to consumers. This brought immediate results by both increasing sales and lowering costs. Also, the POS efforts significantly improved our relationships with major retailers, who benefited from the product sales support.

As the joint venture established itself more solidly in Beijing, other local distributors asked to sell its product. After seeing different proposals, we selected qualified distributors in Chengdu, Sichuan Province; Guangzhou, Guangdong Province; and Shanghai who were prepared to buy our product on cash terms. These companies were to distribute the product in their territories using the same marketing strategy that we had used in Beijing.

This arrangement helped generate immediate sales as the distributors quickly ordered inventory to place in retail locations. However, the shortcomings of this distribution arrangement soon emerged. When evaluating the distributors, we had not taken into account their lack of marketing or inventory-tracking skills.

Most local distributors in China, including ours, are just traders who rely on product turnover and cost control to make profits. They generally lack the skills or willingness to engage in substantive marketing efforts. As a result, while our distributors maintained good relationships with retailers in terms of account settlement, they did not secure good retail space or market the product well. When it came to inventory management and tracking, they did little

more than collect on their sales and order new inventory when stock was low.

Shifting focus to distribution

After working directly with retailers and other local distributors, we realized the value—and scarcity—of comprehensive distribution services. We decided to change our business focus from selling nutritional supplements to product distribution and began to adapt our operations accordingly.

We fortified sales efforts in Beijing, determined to provide better sales service than any other distributor. We kept retailers well-supplied, and they allowed us to secure the best shelf and counter space for our product. Our POS staff at the retail outlets have established a strong rapport with both store staff and regular shoppers. They can be seen during weekends at any of the major shopping centers in Beijing, including the Lufthansa Center, Sci-Tech Plaza, and Parkson.

With Beijing as our model, we developed a new national distribution plan. The objective was to maintain control of marketing and information flow while using our distributors' sales networks. We altered our distributor prices to include the costs of marketing, which we would manage, and we preserved our cash-based sales policy to reduce our inventory costs. We hired regional managers whom we assigned to both existing sales territories and new, undeveloped territories. These managers provide sales services to our distributors and use our Beijing operations as a model for marketing our product locally.

To stay within legal prohibitions on foreign participation in distribution services, Starcon negotiates deals in the United States so that the products that the joint venture sells in China legally belong to Starcon. Starcon also does some packaging domestically to fulfill legal requirements. As needed, Starcon will form domestic companies to handle sales transactions and, through a representative office or wholly foreign-owned enterprise, manage sales operations.

As a result of this strategy, we now distribute in more than 16 major cities in China. We had to identify new distributors in Chengdu and Guangzhou to replace the original ones, who did not like the change in pricing. Nevertheless, we enjoy successful relationships with our current distributors, who have benefited from our strategy. With able managers at sales sites, we have been able to project a good product image and maintain productive relations with our distributors and key retail accounts while identifying other potential distributors for additional products in the future. Though we have yet to distribute any products other than the original nutritional supplement, we are preparing to sell five Twinlab Corp. products within the next quarter. We are registering four other products manufactured by Rexall Sundown Inc., which

will be sold under the Rexall brand but recognized as Starcon products.

Things we did wrong

No business can expect everything to proceed smoothly, especially in the early stages. Mistakes and problems are inevitable and provide valuable learning opportunities. Nevertheless, Starcon made two mistakes that were especially costly and could have been avoided with more careful consideration.

From the start, we should have played a more active role in the joint venture. A business cannot grow remotely, especially in a difficult market like China's. We unfairly and unrealistically expected local staff—who had had no exposure to US business standards—to run the business as we would in the United States.

Unfortunately, we essentially repeated this mistake, if on a smaller scale, by assigning unqualified personnel to regions into which we expanded our operations. Though this experience taught us much about the decisionmaking process of local distributors, it was a hard way to learn. Replacing a distributor is very difficult and unpleasant, and our initial sales structure forced us to do so twice.

Things we did right

Starcon is fortunate to have survived its mistakes. Our survival, however, was due in no small part to several key decisions—some of which we did not appreciate at the time—that helped us set a strong foundation for our business.

Unlike many new businesses in China, Starcon decided to enter the market cautiously. Admittedly, this was partially due to the fact that we had no clear objectives and no personnel to oversee the business. Our conservative approach forced us to be very resourceful in solving problems rather than spending our way through them. Today, though we have more resources available to us than before, our cost structure is much lower than those of other foreign companies even though our operations are at least as effective.

From the start, we demanded that our distributors buy our goods outright without even considering other options. We knew that we did not have the resources to recover bad debts, and we knew that the legal infrastructure to do so was not as strong as in the United States. This decision saved us from falling victim to the rampant problems of uncollectable accounts receivable, which have plagued many foreign and domestic companies. We expect to set up a credit system at some point, but until distributors prove their long-term reliability, and until the legal system provides better support, we will maintain our cash-only policy.

From the time that Starcon took a direct role in operations, the joint venture has placed a strong emphasis on human resources—specifically, employee relations and training. We as-

signed the human resources responsibilities to our best local manager. The local human resources manager and I spent most of our energy finding and hiring qualified staff who fit our organization. Even though we were a small company, we believed that these efforts would pay off in the long run. Now, our core group of personnel is one of the primary strengths of the business, and with this team in place, recruiting top talent is becoming easier.

Preparing for WTO, hypermarkets, and the modernization of retailers

China's expected World Trade Organization (WTO) entry is a mixed blessing. The projected tariff reductions will provide welcome relief, as we import most of our products. Our company, our clients, the rest of the distribution chain, and the consumer will benefit. On the other hand, these tariff reductions, coupled with the easing of many trade restrictions, will almost certainly bring more competition from international corporations.

Most important, the founding and growth of chain hypermarkets will change the way we do business. International retail chains such as Carrefour SA, Metro AG, and Wal-Mart Stores, Inc. are beginning to make inroads into China, while domestic chains such as Lianhua Supermarket Co. Ltd. are rapidly consolidating in an effort to beat international corporations to the punch. As the retail industry expands and retailers become more sophisticated, up-to-date merchandising strategies will help overall industry sales. Retail chains will also have more negotiating leverage over their suppliers with regard to pricing, payment terms, and quality of service.

We expect to face greater pricing pressure as retailers avoid regional distributors and increasingly work directly with us. Fortunately, however, retailers are also likely to handle more of their own distribution logistics. We must continue to add unique and branded products to prepare for the likelihood that companies will introduce competing brands. We will also need to build cost advantages, possibly by becoming more involved in the manufacturing end of operations.

The company's growth and the ongoing development of the Chinese economy will thus likely bring new hurdles in the future. For instance, our expansion in products, sales territories, and overall sales will strain our infrastructure. We will need to remain focused on our ability to compile and process inventory and sales data. With analytical and marketing skills at a premium in the marketplace, our human resources department will face considerable pressure to ensure that the necessary skills are available within the company. Fortunately, we have been able to learn from our mistakes in the past, and will continue to do so in the future, as we fine-tune our business and operations. 完

Our conservative approach forced us to be very resourceful in solving problems rather than spending our way through them. Today, though we have more resources available to us than before, our cost structure is much lower than those of other foreign companies even though our operations are at least as effective.

China's New Telecommunications Regulations and the WTO

Jamie P. Horsley

A recent set of regulations paves the way for a WTO-compatible national law

Jamie P. Horsley

is an attorney who lived and worked in China for 13 years as a lawyer, diplomat, and corporate executive. She continues to speak and write on developments in China.

This article is the first of a two-part series looking at the legal framework of China's telecommunications sector. The second article, which will address China's treatment of the manufacture and trading of telecommunications products in the lead-up to World Trade Organization entry, will appear in the September-October issue.

Not yet ready to enact a comprehensive telecommunications law, but mindful of the need to establish a national regulatory framework in anticipation of China's impending entry into the World Trade Organization (WTO), China's State Council issued the Telecommunications Regulations of the People's Republic of China (the Telecom Regulations) on September 20, 2000. The Telecom Regulations represent a welcome first effort by a national rulemaking body to standardize the administration of China's rapidly changing telecommunications industry. These regulations will also help prepare and position China to undertake many, though not all, of its telecom-related WTO commitments.

China has agreed to abide by the WTO's Basic Telecommunications Agreement (BTA), together with the accompanying Reference Paper on regulatory principles and Chairman's Note when it joins the WTO. Pursuant to these commitments, China will have to implement pro-competitive policies in the areas of regulatory independence, competitive safeguards, interconnection rights, universal service, transparent licensing procedures, and allocation of scarce telecom resources. China has also agreed to follow a technology-neutral policy towards the provision of telecom services, which means foreign suppliers can use any technology they choose (including satellite, cable, and other delivery means) to provide such services, as well as to permit direct foreign investment in telecom services (see *The CBR*, May-June 2000, p.12). China will also have to apply the WTO's "national treatment" principle to imported telecom equipment and liberalize its investment restrictions on and requirements for foreign companies that manufacture telecom equipment in China.

A discussion of certain key provisions of the Telecom Regulations and the current regulatory environment in China for telecom services and equipment reveals how far China has come in setting up a legal framework to meet its WTO telecom obligations.

Definitions and categories

The 81-article Telecom Regulations aim to regulate the telecom market in China, protect the interests of both the subscriber and operator, and ensure the safety and security of the telecom network and information. The regulations open the field to non-state-sector participants, including individual and foreign investors. The regulations also establish network interconnection rights for non-dominant operators, a permit system for licensing operators, cost-based pricing (tariffs), a fee-based, centralized auction system for allocating telecom resources (such as spectrum and satellite orbit positions), regulation of telecom services including universal service, centralized administration of the construction of telecom facilities, principles on network-access permits for telecom facilities, network safety and security requirements, and fines and penalties.

The regulations apply to all telecommunications and telecom-related activities within China. Telecommunications is defined broadly to mean any activity whereby voice, text, data, images, or any other form of information is sent, transmitted, or received through wired or wireless electromagnetic or optical systems. According to drafters of the regulations in China's Ministry of Information Industry (MII), this definition is intended to encompass broadcast networks, the Internet, and related services, providing a legal basis for regulating the "convergence" of information technologies.

The Telecom Regulations further break down telecom, in an annex, into "basic telecom services" (sometimes referred to in the industry as tier-one, or facilities-based, services supplied in real-time) and value-added services (VAS, also known as tier-two, or services-based). Tier-one services include fixed domestic long-distance and local telephone; international communications infrastructure and business; mobile telephone and data; satellite communications and mobile satellite communications; Internet and other public data transmission; leasing and sale of bandwidth, wavelength, optical fiber, optical

cable, network channels, and other network elements; radio paging; and resale of basic services. VAS include services in which the supplier adds value to customer information by enhancing its form or content or by providing for its storage and retrieval. The Telecom Regulations list under this category e-mail, voice mail, online information database storage and search, electronic data interchange, value-added fax, Internet access and information businesses, and videoconferencing services.

China's definitions of basic and value-added service are not inconsistent per se with the WTO's General Agreement on Trade in Services (GATS) and the BTA. Given national differences in the definition of basic and value-added services and the rapidly changing technology in the field, the BTA does not define these terms. Under the somewhat outdated GATS Services Sectoral Classification List, telecom services are broken down into 15 subsectors, none of which specifically mentions either mobile communications or the Internet. Negotiators of the BTA generally considered the first seven subsectors of this list (voice telephone services, packet-switched data transmission, circuit-switched data transmission, telex services, telegraph services, fax services, and private leased circuit services), as well as certain mobile communications and other services to be in the catch-all "other" category, as basic telecom services. Some WTO members designate mobile telephony, as well as paging and data transmission services, as VAS, however, and a long-running WTO "e-commerce" group continues to debate how to classify various Internet services. US telecom businesses pressed in particular for China to treat the Internet as a value-added service, which would entail more liberal entry requirements. Indeed, the State Council in 1999 licensed as VAS a joint venture involving AT&T and Shanghai Telecom, which will provide broadband Internet services in Shanghai's Pudong District. As China liberalizes the telecom market, foreign telecom firms hope that the distinction between the two categories will become less important.

Regulatory independence

The "information industry regulatory authority under the State Council," generally considered a reference to MII, is given responsibility for supervision and management of the industry at the central and provincial levels. Other agencies are still vying for control of certain telecom activities, such as Internet via cable, but MII thus far seems to be successfully making its case for overall supervisory authority.

The Telecom Regulations establish the welcome principle of separating government administrative duties from enterprise business. As a legal matter, the former Ministry of Post and Telecommunications (MPT) spun off of its original operating activities into China Telecommunications Corp. (China Telecom) during 1993-

95, prior to the establishment of MII in 1998. Given MII's past financial and operational involvement with China Telecom and its continued role in price-setting, network construction, and other matters, the key to realizing this independence is whether MII will be truly impartial among domestic operators that include a still-dominant China Telecom, as well as among foreign operators who will eventually be able to participate in the sector. Auspiciously, the Telecom Regulations also commit the regulator to breaking up monopolies, encouraging competition, and promoting development, openness, equity, and fairness.

Foreign investment in services

China has committed in its WTO market-access agreement with the United States (the US Agreement) to open its telecom services market to foreign investment gradually. Foreign investment in telecom operations is banned under current administrative regulations issued by MII and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). The Telecom Regulations are intended to apply to foreign investment in telecom enterprises and business. Article 10 of the Telecom Regulations specifies that operators seeking a license to provide basic service must have at least 51 percent Chinese ownership, suggesting that foreigners will ultimately be able to own up to 49 percent. The Telecom Regulations also set no minimum Chinese ownership percentage for applicants seeking a license to provide VAS. The regulations defer details on the exact handling of foreign investment in telecom business to specific regulations to be issued separately by the State Council.

According to the US Agreement, China will progressively open its telecom services market to foreign companies in three phases, which vary in timing over three different categories of services: VAS (which China agreed would include Internet services for this purpose) and paging, mobile voice and data services, and domestic and international basic fixed-line services. Foreigners will be able to acquire 30 percent ownership in VAS and paging in Beijing; Guangzhou, Guangdong Province; and Shanghai immediately upon China's accession and up to 50 percent ownership anywhere in China within two years of China's WTO entry. This commitment conflicts with the cap on foreign investment in basic services, which the Telecom Regulations define to include paging and Internet. Presumably this conflict can be resolved by the stipulation of an exception in the forthcoming regulations on foreign investment in the telecom industry.

According to the terms of the European Union's (EU's) WTO market-access agreement with China, which under the WTO's Most Favored Nation principle will apply to US and other foreign investors, foreign ownership in mobile communications ventures would reportedly be permitted immediately upon China's WTO ac-

China's definitions of basic and value-added service are not inconsistent per se with the WTO's General Agreement on Trade in Services (GATS) and the BTA.

MII will have to institute so-called “competitive safeguards” to prevent any “major supplier” such as China Telecom or its spin-off China Mobile from engaging in anticompetitive practices.

cession, with up to 49 percent ownership phased in over three years. The third category to be phased in is basic fixed-line services—including voice, packet-switched and circuit-switched data transmission, fax, and international closed-user-group voice and data services—which will open three years after accession and rise to 49 percent foreign ownership anywhere in China by year six.

Beijing, Shanghai, and Guangzhou constitute China’s key telecom services corridor, accounting for roughly 75 percent of all domestic traffic. This corridor will open to foreign investment in the three categories of telecom services during the relevant Phase I. Phase I varies among the three categories: immediately for VAS, one year for mobile and data (but immediately under the EU agreement), and three years for basic. Another 14 cities (Chengdu, Sichuan Province; Chongqing Municipality; Dalian and Shenyang, Liaoning Province; Fuzhou and Xiamen, Fujian Province; Hangzhou and Ningbo, Zhejiang Province; Nanjing, Jiangsu Province; Qingdao, Shandong Province; Shenzhen, Guangdong Province; Xi’an, Shaanxi Province; Taiyuan, Shanxi Province; and Wuhan, Hubei Province) will open during the relevant Phase II (one year after accession for VAS, three years for mobile and data and five years for basic services). All of China will be open to foreign investment in all telecom services six years after China’s WTO entry.

Enhancing competition

● Competitive safeguards

Under the BTA’s regulatory principles, MII will have to institute so-called “competitive safeguards” to prevent any “major supplier” such as China Telecom or its spin-off China Mobile from engaging in anticompetitive practices—including cross-subsidization—using information obtained from competitors with anticompetitive results, and not making available to other suppliers on a timely basis technical or commercial information necessary for them to provide service.

China still lacks an antimonopoly law; the 1993 Anti-Unfair Competition Law has yet to be applied to the telecom sector because state-owned enterprises still dominate provision of public services. But an antimonopoly law is being drafted and, in line with the introduction of managed competition into the telecom market and China’s commitments under the BTA’s Reference Paper, Articles 41 and 42 of the Telecom Regulations do establish some basic procompetitive principles. The articles prohibit unreasonable cross-subsidization of other businesses, actions that attempt to limit subscribers from using services of other operators, and engaging in unfair competition through provision of below-cost service. In addition, an operator may not limit subscribers to using only services or equipment the operator designates, refuse or delay service without a legitimate reason, increase rates or the items for which it charges fees without authorization from the regulator or the customer (as the case may be), make

false or misleading statements, or refuse to carry out its commitment to subscribers.

● Interconnection

The interconnection provisions of the Telecom Regulations cover the basic principles of the WTO’s BTA Reference Paper by requiring that “leading telecom operators” not refuse other operators’ requests for interconnection to public networks and that interconnection be handled on the principles of technical feasibility, economic reasonableness, fairness and impartiality, and mutual coordination. Leading operators are to work out—and file with MII—nondiscriminatory and transparent interconnection procedures. The operators must also “unbundle” network elements they sell, so that the supplier need not pay for network components or facilities that it doesn’t require to provide service. Disputes over the terms of interconnection arrangements and their implementation can be submitted to MII or the provincial-level telecom bureaus for mediation.

● Licensing criteria

Consistent with the BTA’s requirement of transparent licensing conditions, the Telecom Regulations set forth the basic requirements for a government license to engage in basic telecom business, set a time limit on when decisions are to be made, and require that the reasons for any denial be made known to the applicant upon request.

To obtain a license to offer basic telecom services, an applicant must be a company specializing in basic telecom business, with Chinese ownership share or shareholders’ rights of at least 51 percent; have a feasibility study and a technical proposal for forming a network; have adequate capital and professional staff to undertake business operations; have a business site and corresponding resources for operations; have the creditability (*xingyu*) and capacity to provide long-term services to customers; and meet other requirements stipulated by the state.

Within 180 days of receipt of the necessary documents, MII must either approve a license to engage in basic telecom business or issue a denial and accompanying explanation. The actual issuance of basic service licenses is to be subject, however, to an auction process that has yet to be clarified.

For a license to offer VAS, the applicant need only be a legally established company (with no minimum Chinese ownership stipulated), have adequate capital and professional staff, have the creditability and capacity to provide customers with long-term service, and meet any other state requirements. In addition, if the VAS requires the approval of other departments, these approval documents must also be submitted to the relevant national or provincial licensing authority. Decisions on VAS licenses must be issued within 60 days.

In reviewing applications, the licensing authority is to take into consideration such factors

as the adequacy of a company's capital and staff, credibility, and the impact of the application on national security, network safety, sustainability of telecom resources, environmental protection, and competition in the telecom market. Implementing provisions will have to flesh out the details of how MII and the provincial regulators will evaluate these factors and handle such issues as auctions.

The licensing of foreign-invested operators, to be covered by separate State Council regulations on foreign investment to be issued before China's WTO entry, should adhere to the WTO principle of national treatment. An unofficial draft of such regulations circulated in late 2000 created an uproar by imposing restrictive conditions on eligible Chinese partners and foreign applicants. The draft would have excluded any but the largest international telecom service companies from the market and required that such ventures be headed and run by appointees of the Chinese partner. MII Minister Wu Jichuan promised in a September 25, 2000 press conference in Beijing, however, that China would not impose any annual operating revenue restrictions on investors and that operating permit terms would apply equally to both domestic and foreign-invested operators. Pending the release of the implementing regulations on licensing and foreign investment, the Telecom Regulations' detailing of the basic parameters, setting of a deadline for decisions, and requirement that authorities explain any denial of licenses are particularly welcome improvements on the former licensing system.

● Universal service

Many countries now require telecom operators to help provide service to underdeveloped or poor areas at a reasonable cost. The BTA Reference Paper recognizes the right of nations to require a universal service obligation, but stipulates that such an obligation be administered in a transparent, nondiscriminatory, and competitively neutral manner that is not unnecessarily burdensome. The Telecom Regulations contemplate introducing universal service obligations without specifying the competitive safeguards mentioned in the Reference Paper but promising some form of subsidy or cost recovery. Article 44 requires operators to carry out any relevant national provisions on universal service. MII is authorized either to designate operators or use bidding to determine operators' universal service obligations. Measures on compensating the cost of providing universal service are to be formulated by MII together with the "financial and pricing departments" and approved by the State Council.

● Resource allocation

The BTA Reference Paper requires that procedures for the allocation of scarce resources such as frequencies, numbers, and rights of way should be carried out in an objective, timely, transparent, and nondiscriminatory manner and that the current state of allocated frequency

bands be made publicly available. The Telecom Regulations establish an auction-based system of allocating telecom resources, including radio frequencies, orbital slots, and network numbers. Winning operators, or users, will pay State Council-approved fees. The regulations specifically require leading operators to ensure that such users can utilize their network resources. Again, implementing regulations will likely spell out the details more fully.

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● International gateway

All international communications business in China, including between the mainland and Hong Kong, Macao, and Taiwan, must be approved by, and pass through, an international gateway approved by MII. In connection with its commitment to adhere to the BTA, the Chinese government agreed to act as an impartial, independent regulator.

Transparency and public input

Other provisions of the Telecom Regulations address the provision and quality of telecom services, network construction, and security (which covers prohibited content of communications), which are not directly relevant to China's WTO commitments. To be sure, WTO-related issues may arise in the course of implementing these provisions, as well as the other matters covered by the regulations, and companies will have to monitor China's treatment of foreign investors and suppliers in the PRC telecom market.

The Telecom Regulations introduce the welcome principle of transparency in rulemaking, administrative decisionmaking, resource allocation, and service fees, among other matters. They also indicate that the nongovernmental sector—operators, users, and other relevant parties—will be invited to provide input on such matters as setting government-fixed or "guided" telecom tariffs. Companies hope that the concept of public input will be expanded to additional areas, including the formulation of detailed implementing regulations in all areas of regulation and in the setting of standards for telecom equipment.

Continued on page 41

The Amended PRC Patent Law

Jiwen Chen

The latest version of China's Patent Law brings the country one step closer to compliance with WTO requirements

The amended Chinese Patent Law, which brings PRC patent law closer to World Trade Organization (WTO) requirements, took effect on July 1, 2001. The National People's Congress (NPC) passed the original Patent Law in 1984 and amended it in 1992. The State Intellectual Property Office (SIPO), formerly known as the China Patent Office, began drafting the latest amendments in 1998. The NPC passed the second amended Patent Law on August 25, 2000. The major changes in the amended law can be grouped into three categories: new judicial and administrative protections, improved application procedures, and simplified enforcement procedures.

Better judicial and administrative protections

The new judicial and administrative protections provided in the amended Patent Law eliminate several major differences between the old law and the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs).

● Offering for sale

Article 11 of the amended Patent Law gives patent owners the right to prohibit unauthorized "offering for sale," meaning that no one may offer the patented products for sale, advertise the products, or display the products in a store or trade fair without the express authorization of the patent holder. Requiring such authorization enables the patent holder to prevent infringing products from reaching the market. This remedy is especially important for patent holders in cases where the product is for private use and the manufacturer of the infringing product is not easy to identify. Under the previous Patent Law, the right of the patent holder to prohibit unauthorized third parties' offering for sale was not protected. The amendment eliminates the most significant difference between the previous Patent Law and TRIPs requirements.

● Statutory damages

Under Article 60 of the amended Patent Law, patent infringement damages shall be determined according to the loss incurred by the patent owner, or the profit received by the infringer, as a result of the infringement. When the loss or profit is difficult to determine, the damages shall be a multiple of the patent royalties.

The previous Patent Law did not set a standard for determining infringement damages. In practice, courts usually use the general tort standard of infringement remedies of the PRC General Principles of Civil Law. According to the Supreme People's Court's 1992 Circular on Answers to Several Questions in the Trial of Patent Disputes Cases (Supreme Court Patent Circular), the court may calculate infringement damages based on the patent holder's loss, the infringer's profit, or a reasonable royalty. Previously under the royalty method, the damages were a reasonable amount not lower than the royalty. Whether or to what extent the compensation levels rise will depend on the amendment's implementation.

● Use or sale of patent-infringing products without knowledge

According to Article 63 of the amended Patent Law, an entity that uses or sells a patented product or a product obtained from a patented process without knowing that it was made and sold without the patent holder's authorization is not liable for damages—if the entity can prove that the product comes from a legitimate source. Under the previous Patent Law, ignorance was sufficient to exempt a seller or user from prosecution for an infringement, severely crippling the enforcement of patent rights. The amended provision now puts the onus on the user or seller of an infringing product to prove that the product is not infringing or face prosecution. This allows the patent owner to control the market better and stop infringing sales.

● Preliminary injunction available

Under Article 61 of the amended Patent Law, if the patent rights owner and the interested party can prove that someone is infringing or will infringe on their rights and that without prompt action they will suffer losses, they may seek an order of injunction from the court and take measures to preserve the property.

To comply with the "expeditious remedy" requirement of TRIPs, the amendment provides a remedy similar to preliminary injunction found in other jurisdictions. The PRC Civil Procedure Law lays out procedures for the preliminary securing of proof and for property preservation, which cannot be used to stop the infringement before a judgement is made. The old Patent Law has no provision on preliminary injunction.

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This is the first time that a Chinese patent law provides a procedure similar to preliminary injunction.

● **Stricter standard for compulsory license**

The amended Patent Law provides a stricter standard for compulsory license than the previous Patent Law. Under Articles 50, 52, and 55, when an invention or utility model that is granted patent rights involves an important technical advance of *considerable economic significance* compared to the prior granted patent, and the exploitation of the later invention or utility model depends on the exploitation of the earlier patent, SIPO may, upon the request of the later patent holder, grant a compulsory license to exploit the earlier patent (emphasis added).

The patent administration department of the State Council (currently SIPO) shall *notify the patent holder* of its decision to grant a compulsory license and shall register and announce the decision (emphasis added). The compulsory-licensing decision shall specify the scope and duration of the license, based on reasons for granting it. When these reasons cease to exist, the patent holder may petition the patent administration department of the State Council to terminate the compulsory-license decision.

If the patent holder or *grantee* (the party that applied for and obtained the compulsory license) is dissatisfied with the patent administrative authority's decision to grant a compulsory license or with the adjudication regarding the royalty payable for the exploitation, either one may, within three months of receiving the notification, appeal to the People's Court (emphasis added).

A provision of the Paris Convention for the Protection of Industrial Property allows member countries to include compulsory licenses in their patent laws. Nevertheless, Article 31 of TRIPs limits the use of compulsory licenses, as developed countries were concerned that developing countries could harm the interests of developed-country companies by granting too many compulsory licenses. The amended Patent Law now conforms to TRIPs requirements.

● **Clearer definition of employment invention**

Under Article 6 of the amended Patent Law, an employment invention is an invention made while performing the tasks of the employer or made by the employee using the employer's material and *technological* resources (emphasis added). In such cases, the right to apply for a patent belongs to the employer. However, if an agreement between the employer and employee provides otherwise, that agreement applies.

Before the amendment, only the use of the employer's materials could qualify the employee's invention as an employment invention. Therefore, the amendment is favorable to employers, especially joint-venture research institutions established by multinational corporations in China. This is different from US patent law, which provides "shopping rights," or the employer's right to use the employee's patent roy-

alty free. The amended law will likely encourage technicians and engineers to innovate.

Improvement in patent prosecution procedures

Foreign patent applicants had problems with the time-consuming and complicated filing requirements for procuring patents in China. The new Patent Law addresses these concerns by relaxing the filing requirements for foreign and in-

The new judicial and administrative protections provided in the amended Patent Law eliminate several major differences between the old law and the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs).

ternational applicants, requiring the patent authorities to examine the application within a reasonable timeframe, and removing the limitations on international applications by domestic applicants.

● **Prior foreign research no longer required**

Under Article 36 of the amended Patent Law, SIPO *may* require an applicant who has filed an application in a foreign country for the same invention to furnish documents concerning any search made for prior art or the reports of such foreign examination (emphasis added). Since SIPO now has adequate searching capacity, the applicant must only submit search reports when required by SIPO.

● **Search report required for utility model**

Under the previous Patent Law, the patent office did not conduct a substantive examination for a patent application for a utility model, which is any new technical solution relating to the shape and/or structure of a product that is fit for practical use. To prevent someone from filing an identical application in bad faith, Article 57 of the amended Patent Law provides that while the patent holder advocates his rights, the courts or the patent administrative authorities may require the utility-model patent holder to show the search report issued by SIPO. Since such research reports are issued after substantive examination, the new requirement can prevent the abuse of patent rights by taking advantage of the non-substantive examination. A substantive examination deals with the novelty, inventiveness, and usefulness of an item for which a patent has been applied, while the nonsubstantive examination deals with procedural, format, and timing issues.

● International application by Chinese entities or individuals

According to Article 20 of the amended Patent Law, any Chinese entities or individuals intending to file a patent application in a foreign country for an invention made in China shall first file an application with SIPO, which will then appoint them a patent agent. Any Chinese entity or individual may file an international patent application.

Provincial-level patent authorities that have jurisdiction can handle any patent infringement dispute.

The old law required a Chinese entity or individual to gain the approval of the relevant administrative authorities before filing foreign or international patent applications but did not define “relevant administrative authorities.” This amendment conforms with Paris Convention and TRIPs procedure requirements and may improve opportunities for foreign-invested enterprises, especially the Chinese research and development centers of multinational corporations, to secure more patents both in China and abroad.

● Agent liability

Article 19 of the amended Patent Law requires patent agents to act according to the power of attorney authorized by the patent applicant during the patent prosecution. A patent agent must keep confidential all of the information it obtains during the course of its agency until the application is published or granted. This article may provide a remedy for patent holders if the agent breaches confidentiality.

Simplified enforcement procedures

The new Patent Law simplifies enforcement procedures in a number of ways:

● Revocation and invalidation procedures streamlined

The amended Patent Law removes revocation procedures to avoid overlap and conflict with the invalidation procedures. Under the old Patent Law, within six months of the granting of the patent, anyone could challenge its validity under the revocation procedure. Now, interested parties can only challenge a patent’s validity through the invalidation procedure.

Articles 45 and 46 of the amended Patent Law lay out the invalidation proceedings. From the date that SIPO grants patent rights, if any entity considers that the granting of the said patent rights does not conform with the relevant provisions of the law, it may request SIPO’s Patent Examination Board to declare the patent rights invalid. The board shall examine the request for invalidation of the patent right in a timely manner, make a decision, and notify the person who

made the request and the patent holder. SIPO must register and announce any decision declaring the patent rights invalid. Any party unsatisfied with the board’s decisions may appeal to the People’s Court within three months of the receipt of the board’s decision. The People’s Court shall notify the counter party of the invalidation proceeding so that it may join the litigation as the third party.

Defendants in patent litigation commonly challenge the validity of the plaintiff’s patent rights. Since most infringement and invalidation cases are litigated in different courts, whether to delay the infringement proceedings until the validity of the patent is resolved becomes a critical issue. According to the Supreme Court Circular, if the defendants in utility-model and design patent infringement cases petition for invalidity within 15 days, the infringement proceeding will be postponed until the validity issue is resolved. However, in invention patent cases, the court may decide. These different procedures exist because the Board has the final say on the validity of utility-model and design patents, while the Board’s decision on invention patents can be appealed. Since all invalidation procedures, including decisions on utility-model and design patents, are subject to judicial review under the amended law, the circular may no longer apply. Observers are also concerned that litigation on utility-model and design patents may take more time, as judicial review is available for these cases.

● Burden of proof

Under Article 57 of the amended Patent Law, where the process invention patent for the manufacture of a new product is involved, any entity or individual manufacturing the identical product must prove *that its process is different from the patented process* (emphasis added).

Although the shift of burden of proof for a process patent for new product litigation is the norm, the amended law imposes another burden on the defendant—to disprove that the infringement occurred. This provision is similar to the US Code, which provides a burden-shifting mechanism if it is likely that the product was made by the patented process and if the plaintiff has made a reasonable effort to determine, but was unable to determine, the process actually used to make the product. Chinese courts seem to impose a heavier burden of proof on the defendant by requiring the defendant to provide such evidence. In contrast, US courts may use their discretion to decide whether the process is different.

● Statute of limitation

Article 62 of the amended Patent Law provides a statute of limitation of two years for actions concerning reasonable royalties for the use of the technology covered by the pending patent application after publication and before the grant of the patent rights.

● Jurisdiction of local authorities

According to Articles 3 and 57, provincial-level patent authorities that have jurisdiction can

handle any patent infringement dispute. If the authorities find that infringement occurred, they can order the violator to stop infringing. If the alleged infringers disagree with the administrative decision, they can appeal to the court. If the alleged infringers neither appeal nor stop infringing, the authorities may request the court to enforce the administrative decision. However, for infringement damages, the local authorities can only mediate a settlement between the parties, provided that the parties agree to such mediation. If mediation fails, the parties may file suit at the People's Court.

Local patent authorities may still investigate and handle the passing off of unpatented products and processes as patented, as stipulated in Articles 58 and 59 of the amended Patent Law. The administrative authorities may impose a fine of between ¥1,000 (\$121) and ¥50,000 (\$6,040) or one to three times the illegal income, confiscate the passed-off products, and order the violators to stop the infringing acts. The punishment decisions imposed by the local patent authorities may be appealed to the People's Court within three months of the decision, according

to the Administrative Procedure Law and the Provisions for Investigation and Handling of Acts of Passing-off Patent.

During the legislative process, opinions were divided with respect to keeping or abolishing these local authorities. The amended law keeps these local authorities and grants clear powers to them. As administrative protection is still an important remedy for combating patent infringement and passing off, close contact with the local patent authorities remains an important strategy in patent enforcement.

Implementing rules expected soon

Before the amended Patent Law took effect on July 1, 2001, the implementing regulations and examination guidelines were expected to be amended as well. Investors hope these rules will clarify outstanding uncertainties about the degree to which the promising provisions of the amended Patent Law will actually protect patent holders' rights. Similarly, as the amended Patent Law does not have transition clauses, SIPO will likely make the necessary transition arrangements in the near future. 完

China's New Telecommunications Regulations and the WTO

Continued from page 37

Toward a telecom law

China has been working on a telecom law for almost 20 years. Rapid changes in both the technology and the industry in China, as well as bureaucratic competition among the various stakeholders in China's telecom industry, have stalled efforts to finalize a draft. As a result, the telecom industry has been governed by a patchwork of administrative regulations. China's impending WTO entry seems to have served as a catalyst to prompt China finally to work out some basic principles and rules that seek to bring order to an increasingly competitive and diversified telecom market and that take international practice and pro-competitive WTO tenets into consideration.

MII and China's legislators should gain concrete experience through the implementation of the Telecom Regulations, enabling the ultimate

adoption of a comprehensive and workable telecommunications law by the National People's Congress. MII chief Wu predicted in March 2001 that the law would be promulgated within two to four years. That long-awaited law will likely be based heavily on the Telecom Regulations and related regulations on the Internet, foreign investment, e-commerce, and other matters.

While the Telecom Regulations provide a sound and generally WTO-consistent framework with which to work, foreign companies hope for the opportunity to contribute to the ultimate formulation of the telecom law both through their active participation in the Chinese telecom services and equipment markets and through consultation on successive drafts. US and other foreign telecom service providers and manufacturers are eager to take part, along with their Chinese counterparts, in advisory bodies to ensure that China continues to develop a transparent, pro-competitive, and effective telecom regulatory framework. 完

China's Next Round of Tax Reforms

Matthew Mui

China attempts to reform and unify its tax regime to meet WTO obligations

China's frequent changes and adjustments to its tax system in recent years have left some foreign investors confused. The pace of change will not slow for some time, however, as China starts overhauling its tax system to bring it into compliance with World Trade Organization (WTO) obligations, encourage investment, close loopholes that can be used for tax evasion, and generally streamline the tax administration process.

In a January 2001 speech analyzing China's 2000 tax revenues, State Administration of Taxation (SAT) Commissioner Jin Renqing indicated that China was ready to carry out reforms of the tax system during the Tenth Five-Year Plan (FYP, 2001-05) period and pointed out the major improvements to the tax system that are pending. Among these are changes that would shift the value-added tax (VAT) burden on capital goods from producers to consumers; expand the scope of VAT; unify the currently separate income tax systems for Chinese and foreign-invested enterprises (FIEs); improve the individual income tax system; and implement the "fee-for-tax reform," under which taxes will replace local fees.

Looking back

China has made many changes to its tax code over the last two years. Some of them benefited foreign-invested and domestic enterprises, but others did not. Among the changes for the better:

- The withholding tax rate fell to 10 percent (from 20 percent) across the country.
- The VAT refund rate on exports returned to the original 17 percent VAT rate for major Chinese export goods.
- The VAT refund and foreign enterprise income tax (FEIT) credit now both apply to the purchase of domestically produced equipment.
- A "super deduction" of an extra 50 percent for FEIT purposes is available for research and development (R&D) expenses that rise at least 10 percent in one tax year over the previous one.
- New tax incentives were offered for foreign investments in China's central and western regions. For example, foreign-invested enterprises are entitled to a reduced FEIT rate of 15 percent for three years beyond the normal five-year tax holiday.

- An FEIT holiday and a reduced VAT rate now both apply to software developers.
- Depreciation of purchased computer software for FEIT deduction was accelerated.
- The transfer and import of technology are now exempt from business tax.
- FIEs can obtain confirmation of FEIT tax holiday status when they begin operations, though the holiday still kicks in during the first profitable year.
- Companies can now offset losses carried forward from previous years against profits from quarterly returns in subsequent years. They no longer need to wait until the annual return.

Changes for the worse include a crackdown on tax incentives, rebates, or refunds granted by local authorities; the requirement that tax clearance certificates be submitted before remitting nontrade payments overseas; and the imposition of a 20 percent tax on interest earned on personal savings deposits.

Shifting VAT on capital goods to consumers

The current VAT system in China is "production oriented," meaning that the tax paid on purchases of capital goods is not creditable against the output VAT collected on sales of the products. Instead, VAT paid on the purchase of capital equipment must be treated as a fixed asset, capitalized along with the costs of capital goods, and depreciated over time. VAT paid on production inputs such as materials and electricity, however, may be offset against the output VAT collected when the final product is sold. This system was introduced during the last tax reform in 1994 to ensure stable growth of tax revenues, prevent the investment boom from overheating, and help keep skyrocketing inflation in check.

In China's current, weaker investment climate, however, the current VAT system is no longer appropriate, for several reasons. First, the production-oriented VAT, which at 17 percent is a significant cost burden, forces businesses to increase investment in capital goods. Second, the system does not appeal to foreign investors because it compares unfavorably with VAT systems in other countries, where VAT credit is often extended to the purchase of capital goods. Finally, a full VAT

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credit on capital goods would enhance the competitiveness of Chinese goods after the country's WTO entry because it would lower costs.

To mitigate these negative effects, the Chinese government is contemplating a shift to a consumption-oriented VAT system, which would allow for an input VAT credit on the purchase of capital goods. This would mean that consumers would bear the cost of the VAT on capital goods purchases. Such a shift may take place in two phases: initially, enterprises may be allowed to deduct the input VAT from the current year's acquisition of machinery and equipment; next, enterprises may be allowed to deduct the input VAT of purchased immovable property. SAT officials are still debating whether such credit should also be granted to existing capital goods retroactively because such a move would cause a significant loss of tax revenue to China and would create complex technical and administrative problems.

Certainly, both the government and foreign and domestic companies consider it desirable for enterprises to be able to claim this input VAT credit on capital goods as long as they are engaged in VAT-related businesses. Input VAT credits for capital goods would lower the costs of manufactured goods—and raise profits—because companies would not have to bear the VAT on the depreciated amount of the capital goods. This would, in turn, encourage the government's aim of more capital investment. In principle, the treatment would be the same for domestically produced and imported capital goods, to comply with the WTO "national treatment" principle. Once input VAT credit for capital goods is available, the present preferential policy of refunding VAT paid on FIEs' purchases of domestically produced capital goods would likely be phased out. In any event, such a preferential policy is not WTO compliant, as it discriminates between China-made and foreign-made capital goods.

The State Council has approved the shifting of the VAT system, but the implementation timeframe could be anywhere from this year to 2005. Most experts think the changes could come as soon as the second half of this year or the first half of 2002.

Expanding the VAT's scope

The current VAT system mainly covers the import and sale of tangible goods, whereas the business tax is levied on labor services, the assignment of intangible assets, and the sale of immovable property within the country and is similar to a sales tax. Technically, business tax and VAT are mutually exclusive. Unlike VAT, business tax is a noncreditable system but should be a taxpayer cost. The simultaneous imposition of both taxes has led to a number of administrative problems for taxpayers and tax authorities.

To solve these problems, China intends to expand the VAT system to cover activities subject to business tax. One proposal suggests completely

repealing the business tax and applying VAT to all activities now subject to the business tax. Another suggests imposing VAT on selected activities now subject to the business tax, namely, construction, transportation, post and telecommunications, sales of immovable property, and all other services of a production nature.

Business tax is a main source of revenue for local governments. This proposed expansion of the VAT's scope at the expense of the business tax could lead to an increase in tension between central and local authorities.

Business tax rates (3, 5, and 20 percent) are generally much lower than VAT rates (6, 13, and 17 percent). Imposing VAT on income originally subject to business tax would inevitably raise consumer prices. To reduce the risk of inflation, new, lower VAT rates may be introduced.

Business tax is a main source of revenue for local governments. This proposed expansion of the VAT's scope at the expense of the business tax could lead to an increase in tension between central and local authorities. This tension could make such reform difficult. More research and negotiation will be necessary before such changes can be implemented.

Unifying the two enterprise income tax regimes

Presently, China has two distinct sets of income tax laws: one for FIEs and the other for domestic Chinese enterprises. Unification of the two tax regimes would enable domestic enterprises and FIEs to use the same principles and criteria in calculating their taxable income. This would foster more balanced economic growth and encourage national treatment, bringing China closer to fulfilling its WTO commitments.

In mid-April 2001, SAT invited scholars, government ministries, multinational corporations, state-owned enterprises, domestic privately owned conglomerates, professional firms, institutions, and other interest groups to express their views on a draft of the unified enterprise income tax law. (Since it was the first draft made available to outside tax organizations for discussions, it is likely to undergo revision and modification before its early 2003 target date for implementation.) SAT focused on six areas:

● Parties subject to unified enterprise income tax

Under the new draft, all businesses will be subject to the unified enterprise income tax. However, the individual income tax laws and regulations also govern business carried out by natural persons. A proposal not to apply the uni-

fied enterprise income tax to partnership or entrepreneurial businesses (privately owned by natural persons) is under discussion.

● **Statutory enterprise income tax rates**

Currently, the statutory enterprise income tax rate applicable to both FIEs and domestic enterprises is 33 percent, but Chinese government statistics show that the effective tax collection rates are just 15 percent for FIEs and 25 percent for domestic enterprises. This situation reflects the various tax incentives offered to different industries and in different localities and indicates that there is room to lower nominal tax rates.

Some tax incentives currently granted to FIEs and domestic enterprises may be reduced and then phased out with grandfather rules to address the burdens imposed on existing enterprises.

The nominal tax rate of 33 percent has led foreign investors to believe that enterprise income tax in China is higher than in other developing countries. The government is now considering setting the unified enterprise income tax rate between 25 and 30 percent, with, perhaps, lower rates for small businesses.

The questions of how to share enterprise income tax revenues between central and local governments and how to implement a reliable tax collection mechanism are also under discussion. Taxpayers are concerned that such a mechanism could prove to be an administrative burden, as was the case with the VAT and business-tax collection mechanisms.

● **Computation of taxable income**

The comprehensive computation formula to determine taxable income is as follows:

Total income - Deductions - Tax losses carried forward - Exempted income = Taxable income

Currently, tax losses can be carried forward for five years. Because of the poor financial situations of many enterprises in recent years, some proposals have suggested extending this period to 10 years.

A new item, "exempted income," will be deducted from taxable income. "Exempted income" has yet to be defined but may include dividends and interest on state and corporate bonds. One ongoing discussion concerns whether it is more reasonable to put "exempted income" before "tax losses carried forward" because exempted income would be excluded only in the year incurred while tax losses may be carried forward for five years.

● **Tax treatment for assets**

Tax treatment for assets will change significantly from the existing FEIT regulations.

Among the most important changes, SAT deleted the description of the cost basis of self-developed assets and improvement in fixed assets, the definition of assets to be capitalized as fixed assets (currently any purchase worth ¥2,000 [\$242] or more may be considered a fixed asset), and details of depreciation and amortization methods. SAT also introduced articles dealing with fixed assets under operating and finance leases and excluded good will for amortization (and thus tax deduction). More details will be available when implementing rules are released, likely within three years.

● **Tax incentives**

At present, FIEs enjoy tax incentives for which domestic enterprises are not eligible. Though tax incentives for both FIEs and domestic enterprises are unlikely to be abolished overnight, SAT is likely to narrow the gap between the two regimes. Some tax incentives currently granted to FIEs and domestic enterprises may be reduced and then phased out with grandfather rules to address the burdens imposed on existing enterprises. SAT may also phase out tax incentives based on location—other than those for central and western regions—in favor of incentives based on industry (particularly high-technology industries). The term "tax holiday" may be redefined to start from the first year of operations rather than the first year of profit, which may force FIEs to reflect profits as soon as possible in order to utilize the tax incentive, which otherwise would expire. (This redefinition could also be another measure to deter the use of transfer pricing tactics to avoid paying taxes.) Other adjustments, such as tax credits, accelerated depreciation, and expansion of the basis and criteria for deduction of expenses and "super deduction" of specific expenses such as R&D, are also expected.

Other areas of interest to most foreign investors, such as the specific exemption clause for dividends paid by the FIE to its foreign investors, do not appear in the discussion draft. The draft also sets the withholding tax rate for interest, royalty, profits (dividends), and rental at 20 percent, as opposed to the unilateral reduction to 10 percent, effective in 2000.

● **New FEIT return form**

As an intermediate step to the unification of the enterprise income tax regime, SAT "unified" the filing administration ahead of the law. A new FEIT return form plus 23 schedules (increased from four schedules) was adopted for FIEs filing in 2000. The new forms, which include titles such as Policy-Type Tax Incentives, Registered Capital Injection, Movement of Fixed Assets Depreciation, and Summary of Allowable Losses, are in fact very similar to those currently used by domestic enterprises.

Obviously, by using the more complicated form and schedules, the Chinese tax authorities

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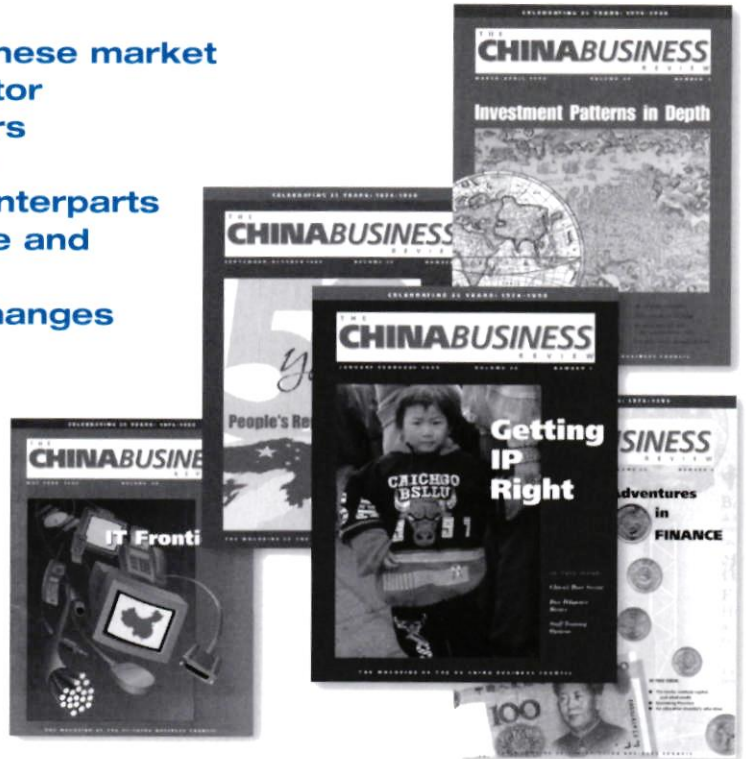
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China Modernizes Public Utilities

Junhao Wang and Ping Chen

As China reforms its public utilities, foreign investors are invited to join in

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China's public utilities have drawn foreign investors' attention over the years, but little information is available about the current extensive regulatory reform of public utilities, broadly defined as infrastructure facilities that offer universal but paid services and products to the public. A look at the details of the reform suggests possible routes foreign companies can take to enter and prosper in the PRC's huge market for water, gas, electricity, telecommunications, and other basic utilities.

Encumbered by inefficiencies

The PRC government has traditionally considered public utilities nonprofit "welfare services" owned, managed, and subsidized by the state. After 20 years of economic reform, public utilities are among the last remnants of the planned economy and thus, not surprisingly, suffer from a variety of problems, including insufficient production and poor management. PRC regulatory policies that call for low prices and high subsidies have created utility firms characterized by high operating costs, low productivity, obsolete technology, and financial losses. The fact that these firms are under direct and strict state control means that they tend to concentrate on production instead of market demand. As a consequence, marketing efforts to identify and satisfy consumer needs have been few, and the old-style thinking of "sales according to production" is pervasive.

Already unable to meet the demands of China's rapidly expanding cities, Chinese utility firms will face a real problem as urban populations increase from 35 percent of China's total population in 2000 to 45 percent in 2010. The products and services of public utilities currently available would hardly meet such huge demand. Indeed, in 1999 *China Investment and Construction* reported that only 10 percent of urban wastewater and 6 percent of garbage was processed—well below the world average.

Twenty-first century: Regulatory reform dawns

Public utility reform involves issues that will affect not only state-owned enterprises (SOEs) but also China's national economy, social welfare, and investment climate in general. As a re-

sult, the PRC government has been proceeding cautiously. The regulatory reforms introduced so far all serve the ultimate aim of establishing market rules, such as legal safeguards, greater transparency, and fair competition, which in turn conform to China's World Trade Organization (WTO) commitments.

Establishing regulations and laws

Under central planning, the state was solely responsible for financing utility projects, dispatching managers, making production plans, and subsidizing losses. In such an "order-and-implementation" relationship between the state and the utilities, in which utilities were subject to heavy government intervention, the utilities' business activities lacked a legal underpinning.

The PRC government has started to replace administrative intervention with a legal framework for utility regulation. New laws that have been approved or are under discussion not only define the status, duties, and rights of the enforcement body of each industry, but also clarify licensing criteria, pricing procedures, and service quality requirements.

National laws currently covering utilities include the Electric Power Law (1995), issued by the National People's Congress (NPC), and the PRC Telecom Regulations, passed by the State Council in September 2000 (see p.34). These laws provide legal guarantees for both government regulation and business operations. However, the water and gas sectors still operate only according to local-level rules and regulations. Water and gas legislation in the more developed coastal cities, such as Dalian, Liaoning Province; Qingdao, Shandong Province; Shanghai; and Shenzhen, Guangdong Province, are most advanced. The NPC is expected to draft and pass national legislation in the water and gas industries and revise versions of the electricity law in the near future.

The PRC government has passed related laws that affect public utility operators, including the Anti-Unfair Competition Law, passed in 1993, which strengthens the regulation of improper competitive conduct in various settings. By the end of 2001, the NPC is also expected to review an antimonopoly law that would restrict monopolies in different guises and the Government

Price-Setting Auction Regulation (*Zhengfu Jiage Juece Tingzheng Banfa*), which would legalize price adjustments by central or local governments for utility products and services.

Introducing competition

The utility industries, as natural monopolies, require large sunk investments that have no alternative economic uses. Once a project is finished, however, cost per unit declines as output increases (within a certain range of output). Thus, in most utilities, a monopoly or oligopoly would, in theory, be most cost efficient. A downside of this phenomenon, however, is that these enterprises may be less motivated to improve management and undertake technical innovations, resulting in inefficiency. Unless prices are supervised, moreover, utilities may be tempted to earn excess profits by monopolistic pricing, also leading to allocative inefficiency. In short, the government needs to play a role in utility regulation, and policymakers in this sector will always face the dilemma of balancing the need for economies of scale with the need for competition.

Though many utility industries are natural monopolies, some industries have both natural-monopoly and competitive components. In recent years, policymakers have tried to allow more firms to enter the utility markets to increase efficiency through competition where possible. The main business of most utilities involves fixed-network operations, such as transmission through water and gas pipelines, power lines, and fixed-network operations in telecommunications. The remaining businesses in these industries—such as wireless phone service—are potentially competitive. Clearly, separating the core natural monopoly from the potentially competitive business would be a practical solution. This was the case in the AT&T breakup in the 1980s in the United States and in the regulatory reform of the British electricity industry in 1989, in which the British government separated the generation, transmission, and sales of electricity. The British National Grid Co. alone operates the monopolistic high-voltage transmission business, but the company is barred from potentially competitive generation and sales, which gradually shifted to several other firms.

In recent years, the PRC has taken similar measures to deregulate its telecom, electricity, gas, and water-supply industries. These policies attempt to reduce entry barriers to attract investors to the competitive parts of the utilities. A case in point is the telecom industry, in which the government created China United Telecommunications Group Corp. (China Unicom) to compete with the state-owned China Telecommunications Group Corp. (China Telecom) in long-distance phone, wireless, paging, and Internet services (see *The CBR*, May-June 2000, p.12, and May-June 2001, p.22). In the power sector, China's policies are likely to focus on separating

the monopolistic transmission business from the more competitive generation and sales business, though California's troubles have slowed the progress of power reform in China somewhat. After China joins the WTO, the government will eventually open all public utility industries to international competition to some degree, with resulting improvements in productivity and service.

Redefining government roles

A number of government offices are responsible for different utility industries. The Ministry of Information Industry (MII) administers the telecom sector and oversees telecom bureaus at provincial, municipal, and county levels. The Electricity Bureau of the State Economic and Trade Commission (SETC) heads the electricity industry and oversees electricity bureaus at each local level. Urban utility bureaus at city or township levels are the only offices responsible for gas and water, as their services are usually confined to specific regions.

The PRC government has set out to redefine its role in utility regulation by separating the administrative and commercial functions of government. The aim is to set up mechanisms to allow firms to operate independently while improving regulatory efficiency by allowing the government to ensure competition. The government is currently considering the establishment of a number of relatively independent regulatory institutions to replace the current telecom, electricity regulation, water services, and gas supply bureaus. These institutions would function as "economic arbitrators" to regulate SOEs, domestic private enterprises, and foreign-invested enterprises under a consistent legal system. According to the reform blueprint, the new offices will be set up after the approval of corresponding laws and mainly employ economists and technical and legal experts from each industry. Their primary responsibilities would be to make detailed regulations and rules, issue licenses, examine pricing and service quality, coordinate and arbitrate conflicts, and prevent unjust competition among utility enterprises.

Redesigning pricing systems

China's public utilities supply the products and services that are inputs to many other sectors of the economy, so their prices affect the cost structure and ultimate prices of the output of those sectors. In addition, utility products and services are necessities for millions of households, and their prices significantly influence living standards. Therefore, in some cases, the government has set prices below costs to prevent inflation. As a result, utility enterprises suffer from funding shortfalls that the government must make up through subsidies.

The PRC government has started reforming this flawed pricing system. The aim of the reform is to raise the prices of utility products and

The PRC government has started to replace administrative intervention with a legal framework for utility regulation. New laws that have been approved or are under discussion not only define the status, duties, and rights of the enforcement body of each industry, but also clarify licensing criteria, pricing procedures, and service quality requirements.

The reform entails using the formula “costs + taxes + returns” to determine prices; reducing subsidies to stimulate utility enterprises to improve management and reduce losses; and establishing new procedures, such as pricing auctions, to increase transparency.

services, so that the utility enterprises can develop further and investors can gain reasonable returns. In practice, the reform entails using the formula “costs + taxes + returns” to determine prices; reducing subsidies to stimulate utility enterprises to improve management and reduce losses; and establishing new procedures, such as pricing auctions, to increase transparency. In a price-setting auction, utility companies provide detailed information concerning their costs and intended new prices. This information is then submitted to and reviewed by the local price bureau. Next, consumers, producers, independent experts, and relevant government offices discuss the rationality and size of the proposed price adjustment. Finally, the government determines prices after taking all of the factors raised during the process into consideration.

All three policies have been carried out with positive results, especially in the coastal areas. For example, in the water sector, the State Development Planning Commission (SDPC) and the Ministry of Construction issued the Urban Water Price Regulation in 1998. Under this regulation, investors gain a net return rate of less than 12 percent while having to pay a value-added tax of 6 percent of the gross margin. The regulation allows local governments to continue setting prices but requires the water companies to provide details on their costs. The most visible result of the law is that more domestic and foreign investors have chosen to enter the water sector since 1998.

New sources of finance

Technology progresses quickly in many utility industries, resulting in the need to replace equipment and supplement investment. Chinese authorities have realized that funding shortages and inadequate investment are among the major causes of the poor condition of PRC utilities and have been diversifying sources of finance in the more developed coastal regions since the early 1990s. Today, in addition to funds from the government budget, construction bonds, and domestic and foreign loans, several other market-oriented financing sources have emerged, most notably stock-market listings and joint-stock companies.

In June 1992, Lingqiao Water Corp. was founded in Shanghai. The first PRC utility enterprise to go public, Lingqiao has successfully raised more than ¥200 million (\$24 million), according to Shanghai's *Wenhui Bao*. By the end of 1999, more than 80 Chinese utility companies had listed.

Auctions of concessions, joint-stock investments, and sales of state-owned properties are all used to attract domestic investment to PRC utilities. In the latest auction, on September 26, 2000, the Hangzhou, Zhejiang Province, municipal government sold the 30-year concession of Chishanbu Water-Treatment Plant to Qianjiang Hydro Development Co. Ltd. for ¥150 million (\$18

million). Established in 1997 and listed in 1999, Qianjiang is jointly owned by the Ministry of Water Resources and two local SOEs. The company specializes in developing small-scale hydropower stations and owns four smaller water-treatment plants across Zhejiang. During the concession period, it will supply water at ¥0.65 (\$0.08) per m³, with guaranteed purchase from the Hangzhou government.

Foreign investment options

Foreign capital has entered the sector in build-operate-transfer (BOT), transfer-operate-transfer (TOT), and joint-venture (JV) projects and, in 1998, represented 10-15 percent of the total utility funding in China, according to *China Investment and Construction*, published by the Ministry of Construction.

● BOT model

Since the Shajiao power plant project began operations in Shenzhen in 1988, the BOT model, in different forms, has been applied to several utility projects throughout China, including the Laibin B power plant project in Guangxi Zhuang Autonomous Region. Advantages of the BOT model include clear risk allocation, competitive bidding and tariffs, and prepackaged approvals (see *The CBR*, July-August 2000, p.28). The BOT model can be used for investment in power-, water-, and gas-supply and wastewater-treatment projects. Some of the largest BOT projects in the near future will be aspects of the west-to-east gas transmission project.

● TOT model

In a TOT project, the private investor buys the property and operational rights of a facility, receives reasonable returns through business operations within a concession period, and then transfers the facility to its original owner for free. The PRC government advocates TOT investments, as a way to overhaul and modernize inefficient SOEs. The purchase of existing public utilities avoids the complications that arise in BOT ventures that involve the construction of facilities from the ground up, which typically encounter cost overruns in the course of construction. Compared with the BOT structure, TOT requires less investment and fewer sunk costs even when upgrades are necessary. Moreover, upgraded facilities often yield more profit than originally expected. The TOT investment model is best suited for telecom, airport, water-transport, and water-, gas-, and power-supply projects because of the number of existing facilities.

● JV model

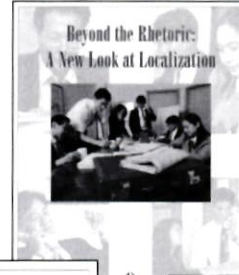
The JV structure, though hardly the most popular investment vehicle for foreign investors, will continue to play an important role because the PRC government wants to retain some control over public utilities for national security reasons. Generally speaking, in any JV utility project, the foreign investor's equity holding would be no more than 49 percent. However, there has been a trend of removing such constraints, espe-

US-CHINA BUSINESS COUNCIL PUBLICATIONS

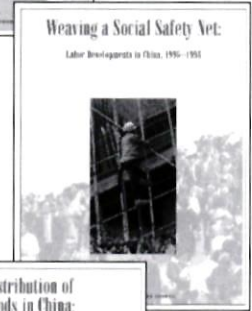
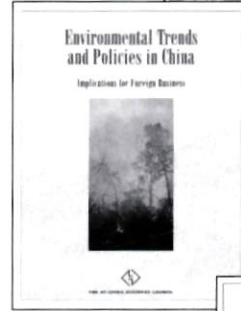
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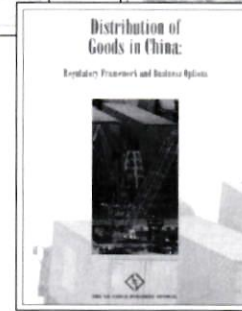


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cially in larger projects. For instance, in the west-to-east gas pipeline project, the foreign partner is allowed to be the holding company, with no limit in the allotment of shares.

Stock investment

Stock investment is another model that, unlike the above three options, does not involve foreign direct investment. Public utilities are generally low-risk and reliable-return investments. In China, rapid industrialization and urbanization will translate into higher demand for utility products and services, which would mean dividend yields well into the future for stock investors. Presently, foreign investors interested in PRC utility stocks may choose from H shares (issued in Hong Kong and New York in Hong Kong dollars), B shares (issued in Shanghai in US dollars and in Shenzhen in Hong Kong dollars), and N shares (American Depository Receipts issued in New York in US dollars). In several years, for-

foreign investors may be able to purchase A shares through JVs. (The most important type of stock for PRC utility enterprises, A shares are issued in Shanghai and Shenzhen in *renminbi*.)

Opportunities for foreign investors should emerge as utility reforms proceed. The number of opportunities will depend on the degree of China's success in a number of areas, particularly the establishment of a legal framework for the various sectors that gives greater legal support to overseas investors and international cooperative projects. Other determinants include the introduction of competition among PRC utilities, the redefinition of government roles to break the administrative ties between the state and its utility enterprises, and a pricing system redesigned to help produce profits. It is also likely that the diversification of financing sources will offer a wider range of entry models. 完

China's Next Round of Tax Reforms

Continued from page 44

will be able to collect more detailed information about FIEs' business operations. The authorities have claimed that they will verify FIE qualifications and conditions for tax-exempt and reduction treatments, scrutinize the deduction of substantial costs and expenses in relation to the taxable profit computation, review operating losses for previous years, and subject FIEs to transfer pricing investigations if necessary.

Individual income tax reform

The ultimate goal of the individual income tax reform is to establish a unified system for different income classes, as opposed to the present schedule-based system. The reforms would likely reduce and consolidate the 11 classes of taxable income; allow a monthly deduction that would apply to both Chinese and foreign employees; allow joint individual income tax reporting for couples with children or parents; subject wages and salaries to monthly filing (other incomes would be reported annually); and reduce the top tax bracket from the current 45 percent. Meanwhile, the Chinese government has also been seriously considering whether and when to introduce inheritance and gift taxes. These taxes are controversial in light of the current economic situation of most Chinese residents.

"Fee-for-tax" reform

In addition to the taxes imposed by central and local governments, local departments at different levels collect numerous fees. Such levies have become the norm, especially in rural areas, where unreasonably high fees imposed by local governments have sparked discontent. Taxes are

structured, foreseeable, well-defined, stable, and legal, whereas fees are arbitrary, unpredictable, negotiable, and often lack a legal basis.

The central government's strategy is to find an organized and manageable replacement for these fees, or, in other words, a local taxation system. The government wants to reform existing taxes to include an urban maintenance and construction tax, a vehicle and vessel usage tax, a real estate tax, a farmland use tax, and a tax on occupation of cultivated land.

A "fee-for-tax" pilot program had been planned in the form of a new nationwide fuel tax, which would have replaced the system of road usage fees. The government postponed the reform because of fluctuating oil prices in 2000. Meanwhile, a few provinces, such as Anhui and Guangdong, introduced a rural fee-for-tax reform last year. The reform immediately repealed the illegitimate fees and is gradually replacing them with taxes. Most companies reportedly welcome these changes.

Tax and the WTO

Some of these tax developments are intended to bring the system into compliance with China's WTO commitments, but other adjustments have arisen to meet the country's domestic needs. Outside pressures for change include WTO mandates related to normal trade relations status, national treatment, and transparency. Internal pressures stem from issues such as preferential treatment for FIEs that disadvantage domestic enterprises and the widening income gap between rich and poor. Given the complexity of the country's legal and economic systems, the Chinese tax authorities have a daunting task ahead. 完

Council Bulletin

Event Wrap-Up

Council Hosts 28th Annual Membership Meeting

The US-China Business Council hosted its Annual Membership Meeting in Washington, DC, on June 12. The program included two panels: "China's Business Climate: An Update from the Region" and "The Investment Landscape: Developments Underway and on the Horizon." The luncheon featured Jeffrey Bader, assistant United States Trade Representative (USTR) for China, who delivered a keynote speech on prospects for US-China commercial relations.

In the first panel, Bruce Quinn, commercial liaison to USTR, spoke about China's preparations for WTO; Iain McDaniels, deputy director of China Operations at the US-China Business Council, discussed Shanghai's investment environment; and Michael Mullen of the National Center for APEC addressed China's customs modernization. In the second panel, Can Eryaman of Lucent Technologies discussed foreign-invested R&D centers; Sheila Melvin of the US-China Business Council spoke about human resources; Annella Heytens of Watson Wyatt Beijing addressed personnel costs; and Tao Jin of PricewaterhouseCoopers discussed new tax strategies for foreign-invested enterprises in China.

Council Hosts APEC Coalition, Plans Summit Business Center

Recent Council Asia-Pacific Economic Cooperation (APEC) activities made significant strides toward arranging first-class support for US business participation in the October APEC CEO Summit in Shanghai.

Council President Bob Kapp convened a breakfast meeting April 30 to exchange views on substantive APEC issues with

Wang Guangya, vice minister of foreign affairs for international organization affairs, who was visiting Washington for official meetings. Vice Minister Wang spoke to a small group of US-APEC Business Coalition (USABC) leaders about China's substantive goals for the mid-October APEC Ministerial meeting and the subsequent Informal Leaders Meeting, the highlight of China's year as APEC chair. Wang stressed the multilateral nature of APEC's intergovernmental work this year, noting that China seeks to ensure that APEC addresses the concerns of all 21 member economies. With respect to business issues, Wang expressed strong support for a successful CEO summit and pledged that government officials and business representatives would have significant opportunities to meet in Shanghai.

The Council also hosted the monthly USABC meeting on May 3. The group heard briefings from Assistant US Trade Representative for Asia Pacific and APEC Affairs Ralph Ives, his deputy Joseph Damond, and US Senior Official for APEC Larry Greenwood on US objectives for the May 26-June 3 Senior Officials Meeting in Shenzhen, Guangdong Province. Kapp briefed USABC on arrangements the Council has made in Shanghai for a business center and meeting room to support USABC activities during the CEO Summit. USABC members also discussed options for defraying business center and meeting room costs and reviewed arrangements for the July 12 State Department APEC CEO Roundtable.

Council discussions with the US Department of Commerce in late May resulted in the Council agreeing to recruit a small group of US companies to attend the August 27-30 Small and Medium-Size Enterprise

(SME) Forum, in Shanghai. This conference will be held at the same time as the APEC SME Ministerial, a government APEC event.

For more information on APEC and the Shanghai meeting, please see www.uschina.org/members.

Washington

May

Issues Luncheon: US-China Relations and the House of Representatives: Defining Expectations for the Year 2001 Featured James McCormick, majority staff director, House International Affairs Subcommittee on East Asia and the Pacific; Peter Yeo, Democratic deputy staff director, House International Relations Committee; Meredith Broadbent, Republican staff of the House Ways and Means Trade Subcommittee; Tim Reif, Democratic staff of the House Ways and Means Trade Subcommittee

Luncheon Featured Wang Yang, vice chairman, PRC State Development Planning Commission

June

Issues Luncheon: The US-China Commercial Agenda in Context: Perspectives from the US Department of Commerce Featured Grant Aldonas, undersecretary of commerce for International Trade, US Department of Commerce

Annual Membership Meeting (*see above*)

Meeting: China Business 2001: Opportunities for the High Tech Sector Featured Iain McDaniels, the Council's deputy director of China Operations in Shanghai. Co-sponsored with the Northern Virginia Technology Council.

Upcoming Events

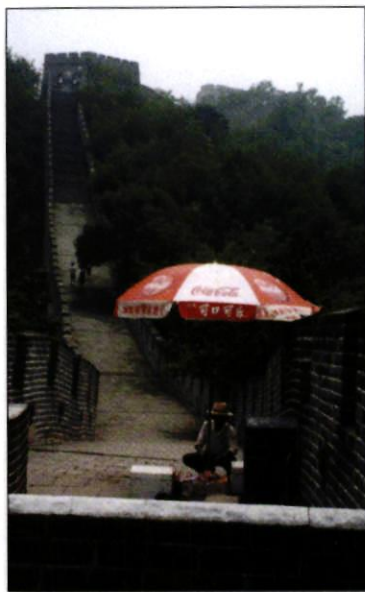
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The company and the country build production, supply, and distribution infrastructures in tandem

Coca-Cola in China: Quenching the Thirst of a Billion

Drake Weisert

The Coca-Cola Company's long history in China sets it apart from the crowd of more recent arrivals. The company built its first bottling plant in China in the decade following World War I and was the first US company to distribute its products in China after Deng Xiaoping opened the country to foreign investors in 1979. Today, Coca-Cola has an ownership stake in 24 bottling joint-ventures—in most cases indirectly through two Hong Kong-based companies that it partly owns: Swire Beverages and Kerry Group. Coca-Cola also operates a wholly foreign-owned enterprise that produces beverage concentrate in Shanghai and is the direct joint-venture partner in a similar facility in Tianjin.

Coca-Cola's long-term strategies of localizing production and building infrastructure through partnerships with the Chinese government and domestic companies have allowed it to establish nationwide operations and generate a strong market presence. Coca-Cola products currently account for 35 percent of China's carbonated beverage market and generate annual sales of up to \$1.2 billion, according to press reports. The company has earned a gross profit in China each year since 1990.

The benefits of the company's success are widespread. A 2000 study by Beijing University, Qinghua University, and the University of South Carolina found that in addition to the 14,000 employees Coca-Cola directly supports in China, the company's suppliers, distributors, wholesalers, and retailers employ an additional 400,000 people (see p.53). Coca-Cola has updated the country's old state-owned facilities, introduced improved product-quality testing, and provided training programs for managers in the industry. The company's total investment in China during the last 20 years has exceeded \$1.1 billion.

Finding a foothold

China's undeveloped beverage industry in the late 1970s suffered from outdated and decrepit bottling facilities. Only one brand of soft drink was distributed nationally—the rest were limited

to local markets. Foreign investment in China's beverage industry was, and still is, tightly controlled and subject to government approval.

Initially, Coca-Cola imported its products and was only allowed to sell them to foreigners at specially designated retail outlets, such as hotels and Friendship Stores. In the early 1980s the company built bottling plants in Beijing; Guangzhou, Guangdong Province; and Xiamen, Fujian Province, giving ownership of the plants to the central government in exchange for better sales and distribution rights. In 1984, Coca-Cola set up its first joint venture in China, a bottling plant in Zhuhai, Guangdong Province, with the former Ministry of Light Industry (now the State Light Industry Bureau [SLIB], under the State Economic and Trade Commission). The next year the government permitted the company to sell its products to the Chinese people. Since then, Coca-Cola has been steadily expanding its operations and now has 24 bottling facilities—which include a total of 28 bottling lines—in 21 cities, as well as the two concentrate plants. The company has also established a strong presence in Hong Kong Special Administrative Region: last year Coca-Cola's Hong Kong office became its Asia-Pacific headquarters, serving 43 countries.

Coca-Cola sells its internationally known drinks in China: Coca-Cola, Fanta, and Sprite. The company sells Diet Coke in a few regions and is only just beginning to market it across the country. The company has also developed local brands through Tianjin Jin Mei Beverage Co., Ltd., a 50-50 equity joint venture formed in 1993 by Coca-Cola and SLIB. In 1996, Coca-Cola introduced Tianyudi (Heaven and Earth), a line of noncarbonated drinks that includes mango and lychee flavors, oolong and jasmine teas, and bottled water. Sales of Tianyudi have increased steadily; most of Coca-Cola's bottling facilities now produce these drinks.

Coca-Cola also introduced Xingmu (Smart), a line of carbonated fruit drinks that includes green apple, watermelon, and coconut flavors in 1997. This brand has caught on quickly in China and now outsells Tianyudi four to one, according

Drake Weisert
is assistant editor of *The CBR*.

to the joint university study. A recent national survey of the beverage market found that Xingmu is among the top five brands in terms of sales in China's carbonated soft drink market. The trademarks for both Tianyudi and Xingmu belong to Tianjin Jin Mei.

"Think local, act local"

China is not the only country for which Coca-Cola has adapted its products and business strategies. The company has taken up the "think local, act local" approach around the world over the last decade. Asia is an important test case, as the diversity of cultures and income levels does not provide a unified consumer base. The company encourages local managers to develop new drinks, and regional offices have the freedom to approve local initiatives. In 2000, Coca-Cola introduced 19 brands across the Asia-Pacific region, and it may launch up to 35 in 2001, according to its website. Though this business strategy seems to be effective thus far—sales increased 8 percent in Asia-Pacific in 2000—some analysts have warned that the company risks overextending its operations. Coca-Cola's future in China, and in the rest of the world, will depend on its success in balancing localization with the maintenance of a clear, profitable product line.

Coca-Cola has also given local managers control over advertising operations. In China, Coca-Cola has included everything from Chinese zodiac animals to Spring Festival couplets in its

television commercials. The company also devotes significant funding to advertising, spending \$26.1 million in China in 2000—more than any other foreign company and 20th overall, according to a survey by ACNielsen Media International. This approach, combined with a relatively long advertising history in the country (in

Coca-Cola's future in China, and in the rest of the world, will depend on its success in balancing localization with the maintenance of a clear, profitable product line.

1984, Coca-Cola was the first foreign company to advertise on CCTV, China's central-government television station) has made Coca-Cola the most recognized soft-drink brand in China for six consecutive years, according to a recent CCTV survey.

In an interesting example of localization, Coca-Cola initiated a cooperative effort with some of Shanghai's neighborhood committee heads in 1996 to build brand awareness and sell products. These neighborhood officials, who are usually retired elders and oversee around 200 families, agreed to sell Coca-Cola drinks for a commission. According to Coca-Cola's Shanghai division chief, the benefits for the company in terms of advertising were important, even if the sales were modest.



Photograph courtesy of The Coca-Cola Co.

A Joint Study Traces Coca-Cola's Economic Impact

Three universities—one American and two Chinese—collaborated in 1999 on the first comprehensive analysis of the effect of a large enterprise on local Chinese economies. For the study, economists from the University of South Carolina, Beijing University, and Qinghua University collected data from The Coca-Cola Company's bottlers on local sourcing patterns along with 1998 employment, tax, and marketing figures. Researchers also interviewed individuals involved in Coca-Cola's distribution, production, and marketing networks. In addition, 400 shop and restaurant owners in four disparate regions in China—Guangdong Province; Harbin, Heilongjiang Province; Shanghai; and Xi'an, Shaanxi Province—filled out surveys on everything from their employment history to consumer preferences to how they obtain, display, and advertise the soft drinks they sell.

The economists then analyzed the data collected in these surveys and interviews using an internationally accepted methodology that estimates the multiplier effect, or the indirect economic influence, of a compa-

ny's investment and operations. Their calculations also utilized China's official input-output model, which traces the domestic effects of economic stimulus. The results of the study, released in 2000, show the broad and diverse impact of Coca-Cola's business on local companies and government revenue.

According to the study, Coca-Cola, which directly employed around 14,000 Chinese at that time (it now employs over 15,000), indirectly supports the jobs of another 400,000 suppliers, wholesalers, and retailers—an employment multiplier ratio of about 1:30. And while the company paid ¥400 million (\$48 million) in taxes to the Chinese government in 1998, its suppliers and distributors paid another ¥1.2 billion (\$140 million). The results also point to the less tangible effects of Coca-Cola's operations in China: better quality control along the supply chain, the stimulation of entrepreneurial activity inside and outside of the company, and the increase in sophistication of the beverage industry as a whole.

—Drake Weisert

In its efforts to locate supplies in China, Coca-Cola provided domestic companies with financial assistance and technical advice to develop equipment and improve quality standards. Coca-Cola provided technical assistance, for example, to several state-owned glass factories in the early 1980s to improve the quality of their bottles.

The supply dilemma

The supplies Coca-Cola requires to run its business in China include packaging materials, drink ingredients, bottling-line equipment, construction services, and business and financial services. Since it opened its first joint-venture bottling plant, the company has worked to build a fully domestic network of suppliers. This has been a challenge, as the company initially had to import basic materials such as glass and aluminum. In its efforts to locate supplies in China, Coca-Cola provided domestic companies with financial assistance and technical advice to develop equipment and improve quality standards. Coca-Cola provided technical assistance, for example, to several state-owned glass factories in the early 1980s to improve the quality of their bottles. All suppliers must comply with "stringent quality standards set by The Coca-Cola Company," says Brenda Lee, director of external affairs, Coca-Cola (China) Beverages Ltd. As a result of its efforts, the company currently only imports around 2 percent of its supplies and has a nationwide network of business partners.

Coca-Cola spends about \$600 million annually on raw materials and packaging supplies in China, but the company does not own shares in any of its suppliers. In the packaging supply industry, the company buys from an equal number of local firms and joint ventures. Some of the new firms emerged to fill a market need, but others are veteran state-owned enterprises that have adopted new technology and quality controls.

Though high-quality packaging supplies are now available in China, qualified personnel are not always easy to find. Local sales and marketing managers, crucial for a business trying to establish a customer base, have been elusive. Coca-Cola, together with the Chinese government, thus set up the Tianjin Soft Drink Training Center in 1988 at its Tianjin bottling facility. This center serves the entire soft-drink industry, not just Coca-Cola, and has trained tens of thousands of people, including bottling plant managers and government officials, in technical and business skills. Coca-Cola also provides university scholarships and funds for school construction as part of its long-term effort to build a pool of educated professionals.

Joining forces

Most of Coca-Cola's bottling facilities are joint ventures with one of three government agencies: SLIB, China International Trust and Investment Corp., and China National Cereals, Oils, and Foodstuffs Import and Export Corp. (COFCO). COFCO has been the company's most frequent partner, holding ownership in 12 of the 24 bottling facilities. In April 2000, Coca-Cola and COFCO signed a milestone joint-venture agreement giving COFCO 65 percent ownership in at least two bottling facilities—the first Chinese majority-owned Coca-Cola bottling joint venture. In addition to government agen-

cies, smaller, local companies are usually involved in Coca-Cola's bottling plant joint ventures as well. These include Dalian Fruits Co. in Dalian, Liaoning Province; Nanjing Perfumery Factories in Nanjing, Jiangsu Province; and Xishan Coal & Electricity (Group) Co. Ltd. in Taiyuan, Shanxi Province.

Swire and Kerry serve as the foreign majority partners in 19 of Coca-Cola's 24 bottling facilities. Coca-Cola holds a 12.5 percent share in both companies and has agreements with them in the areas of plant management, sales, and distribution. Swire is involved in nine of Coca-Cola's bottling facilities based in southern and eastern China. Kerry is a partner in 10 facilities, located mainly in northern and western China.

Coca-Cola is a direct majority partner in four bottling joint ventures: one in Hainan Province, one in Shanghai, and two in Tianjin. The foreign partner in the remaining bottling joint venture, in Zhuhai, Guangdong Province—Coca-Cola's first joint venture in China—is Macau Industrial Limitada, based in Macao Special Administrative Region.

To maintain control over the ingredients and formulas of its drinks, Coca-Cola produces the concentrates for its international-brand soft drinks in a wholly foreign-owned factory in Shanghai—also home to the company's China headquarters. This facility also exports to some Southeast Asian countries. The concentrates for its local drinks are produced in a Tianjin joint venture with Tianjin Jin Mei.

A web of distributors

Most Chinese can afford an occasional soft drink—a can of Coca-Cola costs ¥1.90 (\$0.23) in Beijing and ¥2.30 (\$0.28) in Shanghai today. (Chinese urban and rural per capita incomes in 2000 were ¥6,264 (\$757) and ¥2,255 (\$272), respectively.) Coca-Cola products currently reach about 80 percent of China's population, according to the joint university study. Despite the affordability of Coca-Cola's products and their broad market presence, Chinese people drank, on average, only eight 250-ml servings of Coca-Cola products in 2000—far fewer than the roughly 400 servings that Americans drank last year. But the company sees significant potential for growth as more restaurants, bars, and supermarkets open in towns and cities.

Coca-Cola's own direct-to-retail distribution operation is growing slowly and only accounts for a minority of the company's unit sales in China. To handle distribution and sales to retailers, the company operates at least one sales center in most Chinese cities with a population above 1 million. Most of these sales centers, which also serve as warehouses, are wholly owned and operated by Swire, Kerry, or the relevant bottling company. Fleets of delivery trucks—up to 20 in larger cities—are kept at the centers. Personnel work onsite to coordinate deliveries, and sales staff market the company's products locally, visit-

ing retailers on a regular basis to take orders. Accounting personnel compile periodic financial reports for the company's regional office.

Most of Coca-Cola's products in China are sold through wholesale distributors. Some of the company's partners are large state-owned sugar, tobacco, and wine enterprises (*tang yan jiu gongsi*) that have been distributing products since the 1950s. Others are former state-owned distribution firms, now privatized, that have valuable experience and equipment. Independent wholesalers entered the market as the wholesale industry became lucrative and more competitive in the 1990s and have greatly expanded Coca-Cola's distribution network. Coca-Cola has encouraged the industry's growth by working directly with independent wholesalers, providing technical assistance and offering financial incentives to improve sales.

Independent wholesalers are often small and lack business expertise. Nevertheless, they are adept at finding local retailers and are "willing to put in the hard work and sweat... and happy to cooperate with us," according to Guy Chambers, group manager of sales operations for Swire. In 1999, Swire began an intensive effort to identify the regions in southern and eastern China, down to the township level, where Coca-Cola lacked a market presence. The company surveyed local retailers and then approached local wholesalers with offers to cooperate. This program, called Partnership 101, provides wholesalers with training, management assistance, and often increased sales while allowing Swire to control order management and inventory. "We work from the ground level back," says Chambers, "... independent wholesalers are close to the market and to consumers. Though it takes time to set this up, we have more control in the end."

Swire now works with about 900 Partnership 101 wholesalers, each of which sells from 50,000 to 100,000 cases per year and generates between ¥2.5 million (\$300,000) and ¥5 million (\$600,000) in revenue, according to Chambers. The company's distribution network currently reaches about 215,000 active retail outlets. Chambers describes the typical Swire wholesaler as a family-run operation with four or five people. Beverage wholesalers in large cities in Coca-Cola's distribution network—such as Guangdong (run by Swire), Shanghai (run by Coca-Cola directly), and Beijing (40 percent owned by Kerry)—tend to be larger. Because Coca-Cola owns plants in many of the provinces where it distributes its products, Swire does not rely on airplanes or ships to transport goods and uses trains only minimally. Trucks are the primary means of distribution, with wholesalers often using bicycles at the local level.

Coca-Cola has also worked to create retail opportunities. In 1999 in Harbin and Jiamusi, both in Heilongjiang Province, Coca-Cola and city officials launched a program to provide around 1,000 beverage pushcarts to laid-off

workers. The company provided a day of training for the vendors, including tips on effective sales strategies and vending locations, a pushcart, ice, umbrella, and Coca-Cola T-shirts. According to press reports, vendors earned as much or more than most factory workers—about ¥600 (\$72) a month, depending on sales. Most vendors sold about two cases of drinks a day and

To maintain control over the ingredients and formulas of its drinks, Coca-Cola produces the concentrates for its international-brand soft drinks in a wholly foreign-owned factory in Shanghai—also home to the company's China headquarters.

worked from April to October—the city's cold winters making this sort of work impossible in the winter months. Despite increased overall Coca-Cola sales in the two cities, this program came to an end in 2001 when the Harbin government imposed controls on street vending.

An open bottle

Staying on top in China's beverage industry will not be easy for Coca Cola. The company, along with other foreign soft-drink companies, is eager to see China reform its administrative policies: a new bottling plant currently requires a three-year wait for government approval, and concentrate production volume must be re-authorized annually. China's World Trade Organization agreements with the United States and the European Union do not address soft drinks specifically, though they do address national treatment issues that could level the playing field between foreign and local competitors. Another major hurdle facing the company is an increasingly competitive domestic beverage industry—in part because of Coca-Cola's own efforts to develop the industry's supply and distribution links.

Nevertheless, today China is Coca-Cola's seventh-largest market. The company supplies, produces, and sells almost all of its products within China's borders and employs Chinese citizens to fill the vast majority of its positions. This level of commitment to China, combined with an ambitious strategy that emphasizes localized products and advertising, places the company in a strong position as the country further opens its markets to the world. The company is optimistic about its future; Coca-Cola CEO Douglas Daft recently said that Coca-Cola aims to double its sales in China over the next five years. Even if the company misses this ambitious target, Coca-Cola's long history in China would seem to indicate that it will remain among the top players in China's beverage industry for some time to come. 完

China Business

Sales and Investment

MARCH 16 - MAY 15, 2001

Compiled by Mark Dunn

The following tables contain recent press reports of business contracts and negotiations exclusive of those listed in previous issues. For the most part, the accuracy of these reports is not independently confirmed by *The CBR*. Contracts denominated in foreign currencies are converted into US dollars at the most recent monthly rate quoted in the International Monetary Fund's *International Financial Statistics*.

Firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in *The CBR* by sending the information to the attention of the editor.

Accounting and Insurance

OTHER

Samsung Fire & Marine Insurance, a unit of the Samsung Group (South Korea)

Established Samsung Fire & Marine Insurance Shanghai to offer property and liability insurance services to South Korean enterprises in Shanghai. 4/01.

Wanxiang-Horton Insurance Group, a joint venture between The Horton Group (US) and Wanxiang America Corp., a subsidiary of Wanxiang Corp. (Zhejiang)

Opened representative office in Shanghai. 4/01.

Agricultural Commodities and Technology

CHINA'S EXPORTS

Government of the PRC

Will export 30,000 tons of wheat to South Korea. 5/01.

OTHER

International Fund for Agricultural Development

Will provide Guangxi Zhuang Autonomous Region with a loan for agricultural development. \$30.4 million. 4/01.

Banking and Finance

INVESTMENTS IN CHINA

Lone Star Asia Pacific Investment Co. (US)/Cinda Asset Management Corp.

Formed a joint venture to liquidate some of CCB's bad loans. 4/01.

Western Union Financial Services, Inc., a subsidiary of First Data Corp. (US)/State Postal Bureau of China (Beijing)

Signed agreement to offer Western Union's money transfer services at 250 postal locations in China. 3/01.

OTHER

American International Group, Inc. (US)/China Minsheng Banking Corp. (Beijing)

Signed contract to establish a business alliance in China. 4/01.

American International Group, Inc. (US)/ICBC

Will collaborate on a variety of financial services in China. 4/01.

Singapore United Overseas Bank, Ltd./CCB (Beijing)

Signed MOU to cooperate on a variety of financial sector activities. 4/01.

Fortis (Belgium)

Established representative office in Shanghai. 3/01.

International Data Group (US)

Will increase its investment in China's high-technology sector. 5/01.

Chemicals, Petrochemicals, and Related Equipment

INVESTMENTS IN CHINA

Fuji Photo Film Co., Ltd. (Japan)

Established holding company, Fuji Photo Film (China) Investment Co., to conduct new investments in chemicals, machinery, and light industry. 4/01.

Royal Dutch/Shell Group (the Netherlands)/Sinopec

Will form joint venture, Sinopec Dongting Fertilizer Plant, to produce fertilizer in Hunan Province. (the Netherlands:50%-PRC:50%). \$140 million. 3/01.

Consumer Goods

INVESTMENTS IN CHINA

British American Tobacco Plc (United Kingdom)

Will build cigarette factory in Sichuan Province. 5/01.

Abbreviations used throughout text: ADB: Asian Development Bank; BOC: Bank of China; CAAC: General Administration of Civil Aviation of China; CATIC: China National Aero-Technology Import-Export Corp.; CATV: cable television; CCB: China Construction Bank; China Mobile: China Mobile Communications Corp.; China Telecom: China Telecommunications Group Corp.; China Unicom: China United Telecommunications Corp.; CIRC: China Insurance Regulatory Commission; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNOOC: China National Offshore Oil Corp.; CNPC: China National Petroleum & Gas Corp.; ETDZ: Economic and Technological Development Zone; ICBC: Industrial and Commercial Bank of China; MII: Ministry of Information Industry; MOU: Memorandum of Understanding; NA: Not Available; NORINCO: China North Industries Corp.; P&T: Posts and Telecommunications; PBOC: People's Bank of China; RMB: Renminbi; SARFT: State Administration for Radio, Film & Television; SEZ: Special Economic Zone; SINOCEM: China National Chemicals Import-Export Corp.; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; SDPC: State Development Planning Commission; UNDP: United Nations Development Program

Feng Tay Enterprises Co., Ltd. (Taiwan)

Will increase its mainland production capacity of shoes. \$2.68 million. 4/01.

Mary Kay Inc. (US)

Will increase investment in its China operations. \$28 million. 3/01.

OTHER**Hutchison Tibbett & Britten, a joint venture between Hutchison Whampoa Ltd. (Hong Kong) and Tibbett & Britten Group (United Kingdom)/Beijing Wumart Group Co.**

Will establish a distribution center in the PRC. 4/01.

Electronics and Computer Software**CHINA'S IMPORTS****Perle Systems Ltd. (Canada)/CS&S Network Technology Co., Ltd.**

Signed contract to distribute Perle Systems's IOLAN+ Serial Servers to BOC. \$1.8 million. 4/01.

Videocon International Ltd. (India)

Will export 50,000 Internet televisions to China. \$29.9 million. 4/01.

Avaya Inc. (US)

Won contract to supply data networking systems to the State Electric Power Control Center, a subsidiary of State Power Corp. of China (Beijing). 3/01.

Openwave Systems Inc. (US)

Will provide Shanghai Telecom Corp. with its instant e-mail messaging software applications. 3/01.

CHINA'S INVESTMENTS ABROAD**Hisense Electric Co., Ltd. (Shandong)**

Opened television and DVD manufacturing plant in South Africa. \$3.73 million. 4/01.

Shanghai Haixin Group Co., Ltd.

Acquired electronics manufacturing facility in South Africa to produce television sets. \$4 million. 4/01.

Headway Corporate Resources, Inc. (US)/Shanghai Foreign Service Co.

Signed letter of intent to form software development and IT training joint venture. 4/01.

Loyalty Founder Enterprise Co. Ltd. (Taiwan)/Langchao Electronic Information Industry Co., Ltd. (Shandong)

Formed joint venture, Shandong Loyalty Founder Science and Technology Co., to manufacture personal computer cases. (Taiwan:51%-PRC:49%). \$20 million. 4/01.

Nexans, a unit of Alcatel SA (France)/Tianjin Electromagnetic Wires Factory

Established joint venture, Nexans Tianjin Wires & Cables Co., to manufacture transposed cables. \$28 million. 4/01.

Philips Semiconductor, a unit of Koninklijke Philips Electronics NV (the Netherlands)

Will build an integrated circuit assembly and test plant in Suzhou, Jiangsu Province. \$1 billion. 4/01.

Bitova Electronika (Bulgaria)/Hisense Electric Co., Ltd. (Shandong)

Will form joint venture to produce televisions and DVD players in Bulgaria. 3/01.

Gemplus SA (France)

Will build its Asian integrated circuit card production center in Tianjin Municipality. \$12 million. 3/01.

Hitachi Ltd. (Japan)

Will increase its investment in chipmaking joint venture. \$12 million. 3/01.

Matsushita Electric Industrial Co., Ltd. (Japan)

Expanded its joint venture, Tianjin Matsushita Electronic Components Co., to build new factory space and expand production capacity. \$16.32 million. 3/01.

OTHER**Austria Technologie & Systemtechnik AG**

Received a license to construct an advanced HDI/Microvia printed circuit board plant in Shanghai. 4/01.

TOWA Corp. (Japan)

Established office in Shanghai. 4/01.

VERITAS Software Corp. (US)

Established mainland headquarters in Shanghai. 4/01.

Electro Scientific Industries, Inc. (US)

Established representative office in Shanghai. 3/01.

Hansol Electronics Inc. (South Korea)/Great Wall Computer Group Co. (Liaoning)

Signed agreement to co-manage the Great Wall Computer Group Co.'s factory in Shiyan, Hubei Province. 3/01.

IBM Corp. (US), Legend Digital China, a subsidiary of Legend Holdings Ltd. (Hong Kong)

Will help build e-commerce infrastructures for large Chinese enterprises. 3/01.

Kinetics Group, Inc. (US), SCH Electronics Co., Ltd. (Taiwan)

Signed agreement to help introduce Kinetics's portfolio of products and services in the PRC. 3/01.

Omron Corp. (Japan)/Shanghai Jiaotong University

Formed joint venture, Shanghai Jiaotong University-Omron Software Holdings Co., to export computer software. 3/01.

Toshiba Corp. (Japan)

Shifted its television-set production from Japan to Dalian, Liaoning Province. 3/01.

Worldspan, L.P. (US)/Et-china.com Ltd.

Formed partnership to provide online travel services to domestic and international travelers in China. 3/01.

Engineering and Construction

CHINA'S IMPORTS

The Foxboro Co., a unit of Invensys Plc (United Kingdom)

Won a supervisory control and data acquisition contract for the Shanxi Wanjiashai Yellow River Diversion Project. \$15 million. 3/01.

OTHER

Johnson Fain Partners (US)

Won design competition for the Beijing Central Business District. \$200,000. 4/01.

Environmental Technology and Equipment

OTHER

Government of South Korea

Will invest in PRC tree-planting projects. \$6 million. 4/01.

German Bank for Reconstruction and Development/Government of the PRC

Will provide funds for garbage cleanup and sewage treatment in Qamdo, Tibet Autonomous Region. \$8.96 million. 3/01.

Food and Food Processing

OTHER

Tricon Global Restaurants Inc. (US)

Opened specialty coffee store in Shanghai. 4/01.

Ocean Spray Cranberries, Inc. (US)

Signed agreement with Beijing Huiyuan Beverage Group to distribute cranberry and grapefruit juices in Beijing and Shanghai municipalities and Guangzhou, Guangdong Province. 3/01.

Medical Equipment and Devices

INVESTMENTS IN CHINA

Hong Kong Pharmaceutical Holdings Ltd./Yangzhou University (Jiangsu)

Will construct the Yanda HKP Genetic Engineering Center to research cloning. (Hong Kong:50.82%-PRC:49.18%). 4/01.

OTHER

AstraZeneca Plc (United Kingdom)/Shanghai Jiaotong University

Will cooperate to research the genetic basis for schizophrenia. 4/01.

Metals, Minerals, and Mining

INVESTMENTS IN CHINA

Indalex Aluminum Solutions Group, a unit of Novar Plc (United Kingdom)

Acquired 25% of China Aluminum Group. \$53 million. 4/01.

UCAR International Inc. (US)/Jilin Carbon Co.

Signed joint-venture agreement to produce and sell graphite electrodes in the PRC. 4/01.

Marubeni Corp., Nippon Steel Corp. (Japan)/Jiangsu Fasten Co.

Will form joint venture to manufacture steel cables for bridges. (Japan:25% - PRC:75%). \$16 million. 3/01.

Miscellaneous

CHINA'S IMPORTS

Siti SpA (Italy)

Will supply the Zhong Yuan Group of Guangdong Province with 24 presses to make ceramic tiles. 4/01.

Nickelodeon, a unit of Viacom Inc. (US)

Will launch a 30 minute television show in the PRC. 3/01.

INVESTMENTS IN CHINA

Sino-French Water Development, a joint venture of New World Group (Hong Kong); ONDEO Services, a subsidiary of Suez (France)/Hainan Tianya Water Industry Holding Co.

Will form joint venture to help provide potable water to the city of Sanya, Hainan Province, by acquiring three production facilities. (France, Hong Kong:50%-PRC:50%). \$31.8 million. 5/01.

OTHER

Bakhtar Information Agency (Afghanistan)/Xinhua News Agency

Signed agreement to exchange information and reports. 4/01.

Government of the PRC

Granted the Government of Cuba a loan to develop its telecommunications, tourism, and education sectors. \$380.5 million. 4/01.

Japan Bank for International Cooperation

Will provide the PRC with loans to help construct the Baiyun International Airport in Guangdong Province and to build chemical fiber plants in Hubei Province. \$471.69 million. 4/01.

Perkins Coie LLP (US)

Received authorization to open law office in Beijing. 4/01.

Tourism Industry Association of Canada

Opened office in Beijing. 4/01.

Petroleum, Natural Gas, and Related Equipment

CHINA'S EXPORTS

CNOOC Ltd., a unit of CNOOC

Will provide Chevron Corp. of the United States with 650,000-700,000 barrels of crude oil for processing. 5/01.

CNOOC Ltd., a unit of CNOOC

Will provide Pertamina of Indonesia with 1.1 million barrels of crude oil. 4/01.

CHINA'S IMPORTS

Fluor Corp. (US)

Was selected to provide engineering services for the Bohai Bay Peng Lai 19-3 Phase II Development Project, a joint venture between Phillips Petroleum Co. of the United States and CNOOC. 5/01.

Government of Oman

Signed one-year agreement to supply crude oil to China International United Petroleum and Chemical Corp. 4/01.

Kuwait Petroleum Corp.

Signed contract to provide China International United Petroleum and Chemical Corp. with 7.3 million barrels of crude oil per year. 4/01.

The Republic of Congo

Will supply China International United Petroleum and Chemical Corp. with at least 10,000 barrels of oil per day for one year. 4/01.

OTHER

Santa Fe Energy Resources Inc. (US)/CNOOC

Signed production sharing contract for block 27/10 in the Pearl River mouth basin. 5/01.

Pharmaceuticals

INVESTMENTS IN CHINA

AstraZeneca Plc (United Kingdom)

Opened plant in Wuxi, Jiangsu Province, to manufacture pharmaceuticals. \$100 million. 4/01.

Rexim SA, a subsidiary of Degussa AG (Germany)/Nanning Only Time Pharmaceuticals Co., Ltd. (Guangxi)

Formed joint venture to manufacture amino acids. (Germany:95%-PRC:5%). \$22 million. 4/01.

Ports and Shipping

INVESTMENTS IN CHINA

DHL Worldwide Express (US)

Will build three transfer stations in China to enhance freight transportation. \$9 million. 4/01.

PSA Corp. (Singapore)/Guangzhou Harbor Bureau (Guangdong)

Will form joint venture, Guangzhou Container Terminal Co., Ltd., to manage three container berths. (Singapore:49%-PRC:51%). 4/01.

Power Generation Equipment

CHINA'S IMPORTS

Nordex AG (Germany)

Will provide the PRC with 12 wind turbines. \$5.43 million. 5/01.

INVESTMENTS IN CHINA

Alliant Energy International, a unit of Alliant Energy Corp. (US)

Invested in an 80 MW combined heat and power plant owned by Anhui New Energy Heat & Power Co., Ltd. \$14 million. 4/01.

OTHER

Valence Technology Inc. (US)/Shanghai Optical Communications Corp.

Signed MOU for a technology transfer, allowing Shanghai Optical Communications Corp. to manufacture lithium-ion batteries, using Valence Technology's proprietary material. 3/01.

Property Management and Development

INVESTMENTS IN CHINA

Shangri-La Asia Ltd. (Hong Kong)

Will build new hotels in Fuzhou, Fujian Province and Shanghai. \$400 million. 3/01.

OTHER

Kerry Properties Ltd. (Hong Kong)

Signed letter of intent with the Land Grant Committee Office in Shanghai to develop a residential project. 4/01.

Telecommunications

CHINA'S IMPORTS

Cisco Systems, Inc. (US)

Will provide China Telecom with 500 high-speed Internet routers. \$100 million. 5/01.

Cisco Systems, Inc., Motorola Inc. (US)

Won contract to expand China Mobile's general packet radio service network in Beijing. 5/01.

Guangdong Nortel Telecommunications Equipment Ltd., a joint venture of Nortel Networks Corp. (Canada)

Will provide China Unicom with CDMA equipment for one year in Chongqing Municipality and Heilongjiang, Henan, Hunan, Shaanxi, Shandong, and Zhejiang provinces. \$275 million. 5/01.

LM Ericsson AB (Sweden)

Will supply China Unicom with CDMA infrastructure in Anhui, Heilongjiang, Henan, Jiangsu, Liaoning, Sichuan, and Yunnan provinces. \$200 million. 5/01.

Lucent Technologies (US)

Won contract to deploy CDMA infrastructure in Shanghai Municipality; Inner Mongolia Autonomous Region; and Anhui, Guangdong, Hubei, Hunan, Liaoning, Shandong, Shaanxi, and Zhejiang provinces. 5/01.

Motorola Inc. (US)

Won contract to supply China Unicom with CDMA network infrastructure in Beijing Municipality; Fujian, Gansu, Guangdong, Hebei, Jiangsu, Jilin, Jiangxi, and Shanxi provinces; and Xinjiang Uygur and Guangxi Zhuang autonomous regions. \$407 million. 5/01.

Motorola Inc. (US)

Won contract to expand the GSM 900/1800 networks of China Mobile in Beijing and Tianjin municipalities and Hubei, Jiangxi, and Shanxi provinces. \$146 million. 5/01.

UTStarcom, Inc. (US)

Signed follow-on contracts to provide personal access technology to Zhejiang Province. \$14 million. 5/01.

Alcatel (France)

Signed agreement to expand the seventh-phase GSM network of Shanghai Mobile Communications Co. \$76.09 million. 4/01.

LM Ericsson AB (Sweden)

Won contracts to expand the GSM networks of Beijing Municipality and Hebei, Shandong, and Yunnan provinces. \$400 million. 4/01.

Lucent Technologies (US)

Will provide Xinjiang Uygur Autonomous Region with fiber-optic cable for its long-haul backbone network. \$13 million. 4/01.

Lucent Technologies (US)

Will provide Qingdao P&T Bureau of Shandong Province with optical fiber to increase its metro network services. \$15 million. 4/01.

Luminous Networks, Inc. (US)

Will provide China Netcom Corp. Ltd. of Beijing with PacketWave optical access switches for Chinese metropolitan area networks. 4/01.

Motorola Inc. (US)

Won contract from Hunan Mobile Communications Co., Ltd., a unit of China Mobile, to expand its GSM 900/1800 network. \$213 million. 4/01.

Nortel Networks Corp. (Canada)

Will expand the GSM networks of China Mobile in Anhui, Guizhou, and Hebei provinces. \$105 million. 4/01.

Nortel Networks Corp. (Canada)

Will expand the GSM dual-band network of Ningbo Unicom, of Zhejiang Province. \$31 million. 4/01.

Oy Nokia AB (Finland)

Will supply the Shanghai Machinery Complete Equipment (Group) Corp. with an 800 MHz TETRA mobile digital radio communication system to be used in the Water Conservancy Bureau of Tianjin Municipality. 4/01.

Oy Nokia AB (Finland)

Won contract to supply Hebei Telecommunications Administration, a subsidiary of China Telecom, with a DSL access network. 4/01.

UTStarcom, Inc. (US)

Will provide Yunnan and Zhejiang provinces with city-wide wireless personal access systems. \$35 million. 4/01.

UTStarcom, Inc. (US)

Won personal access systems follow-on contracts in Guangdong and Hainan provinces. \$14 million. 4/01.

UTStarcom, Inc. (US)

Won contract to install broadband metropolitan area networks in five cities in Shandong Province. \$5 million. 4/01.

Vodatel Networks Holdings Ltd. (Macao)

Won contract to expand the integrated digital data network and Frame Relay/ATM of Qingdao, Shandong Province. \$1.41 million. 4/01.

Alcatel (France)

Signed deal to supply equipment for and upgrade the GSM network of Jiangsu Mobile Communications Corp. \$180 million. 3/01.

Alcatel (France)

Will supply China Telecom with 50% of the equipment needed to set up a digital subscriber line network in the PRC. 3/01.

Aura Networks Inc. (US)

Signed contract to supply Guangdong Telecom Corp., a unit of China Telecom, with optical ethernet equipment for broadband access. 3/01.

Marconi Plc (United Kingdom)

Won contracts to supply leading-edge solutions to Ningxia Telecom, a unit of China Telecom, and the Anhui, Fujian, Guangdong, and Shanghai branches of China Unicom. 3/01.

Marconi Plc (United Kingdom)

Won contract to build an inter-company connection to carry voice and data over optical fiber between North China Power Network and North East China Power Network. 3/01.

Nortel Networks Corp. (Canada)

Won contract to provide SARFT with a 3,000 km optical backbone system. \$10 million. 3/01.

Oy Nokia AB (Finland)

Signed contract to expand the GSM 900/1800 networks of Fujian Mobile Communications Co. \$230 million. 3/01.

Oy Nokia AB (Finland)

Won contract to supply Jiangsu Telecommunications Administration, a unit of China Telecom, with a digital subscriber line network. 3/01.

Siemens AG (Germany)

Won contract to expand the GSM networks of China Mobile in Anhui Province and Shanghai, and upgrade them to general packet radio service technology. 3/01.

Siemens AG (Germany)

Will expand the GSM network of China Unicom in Heilongjiang Province. 3/01.

UTStarcom, Inc. (US)

Signed contract to install IP-based personal access systems in Zhejiang Province. \$16 million. 3/01.

INVESTMENTS IN CHINA**Cisco Systems, Inc., Motorola Inc. (US)**

Opened an Invisix Center of Excellence in Beijing to provide customer development activities. 5/01.

FOREM, a unit of Allen Telecom Inc. (US)

Opened facility to manufacture integrated combiners, duplexers, and low noise amplifiers for GSM, CDMA, and TD-SCDMA in Shenzhen, Guangdong Province. 5/01.

Motorola Inc. (US)

Will invest in Leshan-Phoenix Semiconductor Co., of Sichuan Province, to establish a chip manufacturing plant. \$100 million. 3/01.

OTHER**Advanced Micro Devices, Inc. (US)**

Established a software research and development center in Suzhou, Jiangsu Province. 5/01.

Korea Telecom Corp. (South Korea)/China Unicom

Launched an international subscriber dialing service in the PRC. 5/01.

Glenayre Technologies Inc. (US)/China Unicom

Signed agreement to conduct a ReFLEX trial over the Flex Paging Network in Chengdu, Sichuan Province; Nanjing, Jiangsu Province; and Qingdao, Shandong Province. 3/01.

Textiles and Apparel**INVESTMENTS IN CHINA****Daidoh Ltd. Co., NA (Japan)**

Will form joint venture in China to manufacture clothes for the Japanese and overseas markets. (Japan:70%, 30%). \$1.05 million. 4/01.

EMS-Chemi Holding AG (Switzerland)

Won contract from Guangdong Kaiping Chunhui Co., Ltd. to build a polyester filament plant. \$20.3 million. 4/01.

Transportation**CHINA'S EXPORTS****Government of the PRC**

Will extend credit to Pakistan to buy 69 locomotives and 175 passenger cars from the PRC. \$250 million. 5/01.

INVESTMENTS IN CHINA

CNH Global NV (the Netherlands)/Shanghai Tractor and Internal Combustion Engine Corp., a subsidiary of Shanghai Automotive Industry Corp.

Will form joint venture, Shanghai Holland Agricultural Machinery Corp., Ltd., to make small tractors and engines. (the Netherlands:60%-PRC:40%). \$75 million. 4/01.

Ford Motor Co. (US)/Chongqing Chang'an Automobile Co. (Sichuan)

Established joint venture, Chang'an Ford Automobile Co. (US:50%-PRC:50%). \$98 million. 4/01.

General Bearing Corp. (US)

Will increase its investment in Ningbo General Bearing Co., Ltd., a joint venture with China Ningbo Genda Group Co., Ltd. of Zhejiang Province, to 50%. 4/01.

Iveco, a unit of Fiat SpA (Italy)

Formed joint venture with Changzhou Bus Co. of Jiangsu Province to build and sell buses. \$36 million. 4/01.

Sun Hung Kai Properties Ltd. (Hong Kong)/Air China (Beijing), Beijing Capital International Airport Co., Ltd.

Formed joint logistics center in Beijing. (Hong Kong:33%-PRC:34%, 33%). 4/01.

Volkswagen (China) Investments Co., Ltd., a subsidiary of Volkswagen AG (Germany)/FAW Jinbei Automotive Co., Ltd. (Liaoning), Shanghai Automotive Co., a unit of Shanghai Automotive Industry Corp.

Will establish joint venture, Volkswagen Transmission (Shanghai) Co., Ltd. (Germany:60%-PRC:20%, 20%). \$96 million. 4/01.

Compagnie Générale des Etablissements Michelin (France)/Shanghai Tyre and Rubber Co., Ltd.

Established joint venture to produce tires for the PRC market. (France:70%-PRC:30%). \$200 million. 3/01.

OTHER

Rolls Royce and Bentley Motor Cars Ltd., a subsidiary of Volkswagen AG (Germany)

Signed agreement for Bentley China, a member of Dah Chong Hong Ltd., of Hong Kong, to be the sole distributor of its full line of cars in China. 5/01.

The World Bank

Will provide the PRC with a loan to improve the transportation system in Shijiazhuang, Hebei Province. \$100 million. 4/01.

CLASSIFIED

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Ivy League JD & top Chinese LLB, good law firm experience in US, Singapore & China: corporate and project finance, joint ventures, M&A, securities, banking & tax. Seeking legal or corporate job in US. z828@yahoo.com

In a Special Issue of

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September-October 2001

APEC IN CHINA

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