



# CDM Market Update

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POWER & UTILITIES

The global economic crisis, combined with uncertainty as to how negotiations in Copenhagen this December will determine the post-2012 carbon market, have adversely impacted market activity and carbon pricing over the past nine months. In China, the renewables sector continues to develop, though structural hurdles still exist for foreign participants in Clean Development Mechanism (CDM) applications.

## **The global Certified Emission Reduction (CER) market**

As of July 2009, there were over 1,700 CDM projects registered globally, issuing an annual average of over 309 million certified emission reduction (CER) units. It is estimated that these registered projects will deliver another 1,630 million CER units by the end of 2012, when the Kyoto Protocol is scheduled to expire.

However, the current pipeline of projects dwarfs the number of existing projects. According to the United Nations Framework Convention on Climate Change website, there are over 4,200 projects in the CDM pipeline with the potential generate 2,900 million CER units by the end of 2012.

### **CER supply**

The key CER suppliers continue to be located in Asian and Latin American countries. Of all the registered projects, China contributed 34 percent, India 26

percent, Brazil 9 percent, Mexico about 7 percent and Malaysia 3 percent.

Of all CER issued so far, China contributed the most at around 46 percent, followed by India with 22 percent, South Korea with 13 percent (generated by just 28 projects), Brazil with 11 percent and Mexico with 2 percent.<sup>1</sup>

There are many other countries in Asia, Latin America, and particularly across Africa which are generally considered to have great potential, but which have not to date contributed significantly.

### **CER demand**

The economic downturn has resulted in a significant drop in demand for CER units in the European and Japanese markets, as the falling output of emission producing industries has resulted in lower requirements for offsetting.

However, many compliance buyers in

these markets have been using the weaker market as an opportunity to build CER portfolios in anticipation of future upturn. The addition of the aviation sector in the European Union Greenhouse Gas Emission Trading System and the possibility of the caps being applied to the shipping industry have also contributed to higher support in the market.

Further, the US climate bill announced at the end of June, which aims to place the first US limits on emissions of greenhouse gas (GHG), received a positive response in regulatory circles. This has boosted the possibility of the US taking a more active role in the Copenhagen discussions and has resulted in improved market sentiment.

Conversely, progress on the much anticipated Carbon Pollution Reduction Scheme in Australia and the associated market in New Zealand has been significantly delayed and is plagued by new uncertainties. This has adversely

<sup>1</sup> Source: United Nations Framework Convention on Climate Change



affected the CER market across Asia, and has damaged the prospects for either Sydney or Melbourne to develop into a regional carbon trading hub.

Overall, it is expected that the market will continue to be ruled by demand from European and Japanese entities until the US becomes more significantly involved in CER procurement.

### Impact of Copenhagen

The 15<sup>th</sup> Conference of the Parties (COP 15) of the United Nations Climate Change Conference, being held in Copenhagen this December, is expected to be critical for the balancing and resolution of the diverse political, administrative and business perspectives on how to reduce GHG emissions after 2012. Certainly, the various negotiators and stakeholders are holding their best cards close to their chest until they arrive in Denmark.

The uncertainty surrounding the outcome of COP 15 has contributed to the weakness we have seen since this January in the secondary CER market, characterised by reduced volumes and significant price volatility in the low range around EUR 7.5 (in March 2009) to the higher range around EUR 13 (in July 2009) per CER unit. Further, primary CER units have traded at prices as low as 30 percent lower than the CER secondary market prices.<sup>2</sup>

### The Chinese market

Energy security and management has become a critical issue for the Chinese government. A key part of the government's strategy to address this is the ongoing development of the renewables sector.

The 11<sup>th</sup> five-year plan for the period 2005-10 identified a number of key strategies for promoting the renewables sector including, for example, a requirement that 3

percent of the new capacity of large energy companies must be non-hydro renewables, with this figure rising to 8 percent by 2020.

Further, as part of the new Energy Stimulus plan issued in 2008 by the China National Energy Administration, there have been additional market-promoting policies. One key focus area is the development of wind power. The Chinese Wind Energy Association announced on 29 June 2009 that seven wind power bases would be constructed in Gansu province, Xinjiang autonomous region, Hebei province, western Jilin province, eastern Inner Mongolia, western Inner Mongolia, and Jiangsu Province. Out of the 1,500 GW of total electrical output in China, these seven bases together will have a capacity of approximately 120 GW.

The government has also introduced a suite of tax and other incentives to promote the market, which may include the following:

- The income derived by CDM project enterprises from HPC (Hydrofluorocarbons), PFC (Perfluorocarbon) and N<sub>2</sub>O (Nitrous Oxide) projects is eligible for Corporate Income Tax (CIT) exemption for the first three years, and a 50 percent reduction in CIT for the fourth year to the sixth year, starting from the year in which the revenue from the transfer of greenhouse gas emission reductions is first received.
- A project company would be eligible for a 15 percent CIT rate if it is recognised as an advanced and high technology enterprise.

<sup>2</sup> Based on publicly available information from CER trading exchanges.

- The proceeds from the transfer of CERs which are submitted to the State could be excluded from the taxable income for CIT purposes.
- It is speculated that PRC tax authorities might clarify that the transfer of CERs shall fall within the Business Tax regime, but would however provide Business Tax exemption for the transfer of CERs.
- The project companies might enjoy a 50 percent reduction on VAT payable for a company which supplies electricity through wind power.
- A subsidy of RMB 20 per watt of solar photovoltaic generating capacity installed may be provided, for installations of at least 50kW.

### Market challenges

At a recent seminar held by KPMG, government officials identified a number of key concerns:

- CDM knowledge is limited in most companies in China
- The market has a shortage of qualified specialists, particularly DOEs and PDD advisors
- New methodologies for implementation face a slow approval process
- There are not enough experts who can pick up and appropriately apply available methodologies on projects
- The Energy Bureau (EB) has a large backlog of projects awaiting registration.

The last point is particularly noteworthy. By July 2009 the Chinese government had approved more than 2,100

CDM projects, but only 600 had been registered with the EB.<sup>3</sup> These however still represented 34 percent of the global total, while the quantity of annual CERs generated by these projects accounted for 46 percent of the global total.

For foreign investors, there are additional hurdles and challenges which have to be addressed or managed when developing CDM projects in China.

A key consideration relates to the requirement that only China-controlled entities can apply to the National Development and Reform Commission (NDRC) for admission. This means that foreign developers must take a minority stake in a joint-venture for any development if they wish to be eligible for CDM. This regulation has in practice driven some foreign developers who

wish to retain control of their business to turn to the Voluntary Emission Reduction market instead.

However, this rule has recently been relaxed to allow companies based in Hong Kong, Macau or Taiwan to be eligible for application. At a recent seminar held by KPMG China, NDRC representatives indicated that they had reached a verbal agreement with the Hong Kong SAR government that Hong Kong enterprises can be treated as Chinese-owned enterprises and conduct CDM projects in the mainland, provided that certain conditions are met.<sup>4</sup> For example, an enterprise in Hong Kong that applies to conduct CDM projects in the mainland must provide a certificate from the Environmental Protection Department of Hong Kong.



<sup>3</sup> Source: <http://cdm.ccchina.gov.cn>

<sup>4</sup> Source: <http://www.epd.gov.hk/epd/cindex.html> & <http://cdm.ccchina.gov.cn/web/index.asp>

## Contact us

### Peter Fung

Partner in Charge, Industrial Markets  
China  
Tel: +86 (10) 8508 7017  
peter.fung@kpmg.com.cn

### Terry Chu

Partner, Audit  
Beijing  
Tel: +86 (10) 8508 7035  
terry.chu@kpmg.com.cn

### Jean Li

Partner, Tax  
Beijing  
Tel: +86 (10) 8508 7510  
jean.li@kpmg.com.cn

### Melvin Guen

Partner, Industrial Markets  
Beijing  
Tel: +86 (10) 8508 7019  
melvin.guen@kpmg.com.cn

### Norbert Meyring

Partner, Industrial Markets  
Shanghai  
Tel: +86 (21) 2212 2707  
norbert.meyring@kpmg.com.cn

### Matthew Walker

Senior Manager, Infrastructure  
Beijing  
Tel: +86 (10) 8508 5810  
matthew.walker@kpmg.com.cn

### William Cheung

Partner, Industrial Markets  
Guangzhou  
Tel: +86 (20) 3813 8608  
william.cheung@kpmg.com.cn

### Grace Xie

Partner, Tax  
Shanghai  
Tel: +86 (21) 2212 3422  
grace.xie@kpmg.com.cn

### Aaron Lo

Partner, Business Performance Services  
Shanghai  
Tel: +86 (21) 2212 3701  
aaron.lo@kpmg.com.cn

### Eileen Sun

Partner, Tax  
Shenzhen  
Tel: +86 (755) 2547 1188  
eileen.gh.sun@kpmg.com.cn

### Harry Law

Industrial Markets Executive  
Shanghai  
Tel: +86 (21) 2212 3455  
harry.law@kpmg.com.cn

### Rahul Kar

Associate Director, Carbon Advisory  
Singapore  
Tel: +65 6213 2251  
rkar@kpmg.com.sg

### Stephen Lee

Partner in Charge, Advisory  
Hong Kong  
Tel: +852 2826 7267  
stephen.lee@kpmg.com.hk

### Benjamin Ng

Director, Advisory  
Beijing  
Tel: +86 (10) 8508 7034  
benjamin.ng@kpmg.com.cn

### Siew Peng Yeo

Director, Advisory  
Shanghai  
Tel: +86 (21) 2212 2770  
siewpeng.yeo@kpmg.com.cn

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