

CLEAN DEVELOPMENT MECHANISM PROJECTS IN CHINA

a brief guide

Clean Development Mechanism (CDM) projects are a flexible mechanism introduced by art. 12 of the Kyoto Protocol that helps countries listed in the Annex 1 of the United Nations Framework Conference on Climate Change (UNFCCC) – that are required by the Protocol to respect a limit in their Green House Gases (GHG) emissions – to reach their obligations under the Protocol by implementing carbon projects in developing countries (like China, India and Brasil) aiming to achieve a reduction on the emissions level of these countries.

For every certified GHG emission reduction (CERs) resulting from the project – meaning, for every metric tonne of carbon dioxide or equivalent (CO₂e ton/m) that will not be emitted in the atmosphere by the developing country in which the project has been implemented – the project will be granted by the United Nations a corresponding amount of “credits” that will be sold to an Annex 1 country to offset their emissions, directly or through financial intermediaries such as brokers.

CDM projects have been defined as “win-to-win” mechanisms. They assist an Annex 1 party to reach its obligations under the protocol in a more cost effective manner because they implement the project in a country in which it’s cheaper. The projects also substantially contribute to the sustainable development of the developing country in which the project is implemented and provide it with additional funds and advanced technology.

As a non-Annex 1 country, China is not subject to any GHG emissions limit under the Kyoto Protocol. However, as a signatory of the UNFCCC and of the Protocol, it can participate in the CDM mechanism by hosting projects in its territory. The numbers are showing that China has become the favourite site for foreign investors to implement their CDM projects, mainly due to its competitive labor and facilities costs and to a solid legal framework.

CARBON CREDITS MARKET IN CHINA

As of May 2008, around 1,200 projects have already been nationally approved (+400% as of December 2006), while 210 projects have been internationally registered (+500% as of December 2006) and 1,449 projects are on the way to being nationally approved. Of the already nationally approved CDM projects, 625 are hydro-power- around the 50% of the total.

China represents around the 60% of the global carbon credits market

China is the biggest supplier of carbon credits in the world. Alone it accounts for the 60% of the global market, and when combined with India, South Korea and Thailand it accounts for 80% of the global generation of

CERs. Almost all of these credits are bought by European countries and industries to match their obligations under the Kyoto Protocol.

At the moment, an exchange platform for CERs does not exist in China or in Asia in general. Therefore the transfer of credits is realized by negotiations and bi-lateral agreements between parties and brokers. However, as Asia is eager to eat its slice of the cake, there are much more than simple rumors about the establishment of carbon credits exchanges in various Asian financial centers, including Beijing, Shanghai and Hong Kong, that will contemplate products such as contracts, options and futures on CERs.

Hong Kong in particular will probably establish a special green IPOs listing for enterprises that contribute to helping the environment by implementing projects or providing services aimed at reducing GHG emissions

The Beijing platform will probably be established at the well renowned China Beijing Equity Exchange (CBEX), the biggest mainland China exchange, which deals mainly with assets of state-owned enterprises being privatized by the Government and then made available to foreign investors

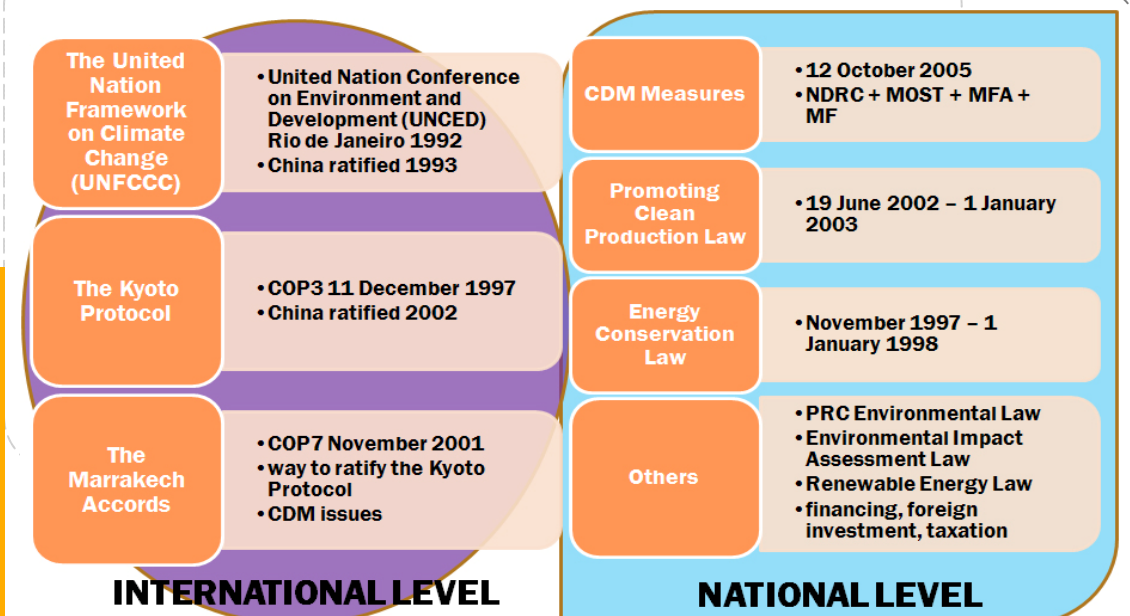
LAWS AND REGULATIONS

The main law governing CDM projects in China is the so called “CDM Measures” (Measures for Operation and Management of Clean Development Mechanism Projects in China), jointly issued on the 12th October 2005 by the National Development and Reform Commission (NDRC), the Ministry of Science and Technology (MOST) and the Ministry of Finance. The law replaces the former “Interim Measures for Operation and Management of Clean Development Mechanism Projects in China” effective since 30th June 2004, and is formulated in accordance with the provisions of the UNFCCC and its Kyoto Protocol and other relevant decisions adopted by the conference of the parties to the UNFCCC.

However, as the matter is strictly related to environment – the environmental impact assessment is an integral part of the validation of a project and is necessary to obtain various environmental permits and licenses in order to build and operate the project – and is also often related to energy – especially renewable energy – the foreign investor should also consider the following laws:

- Environmental Law (1986);
- Energy Conservation Law (1998);
- Promoting Clean Production Law (2003);
- Environmental Impact Assessment Law (2003);
- Renewable Energy Law (2005).

Furthermore, as the project is a form of foreign investment that typically implies the establishment of a commercial joint venture between the project participants, and as it can be structured and financed in various ways according to the specific needs of the participants, laws and regulations pertaining to corporate, financing, foreign investment and taxation should be observed too.



AUTHORITIES

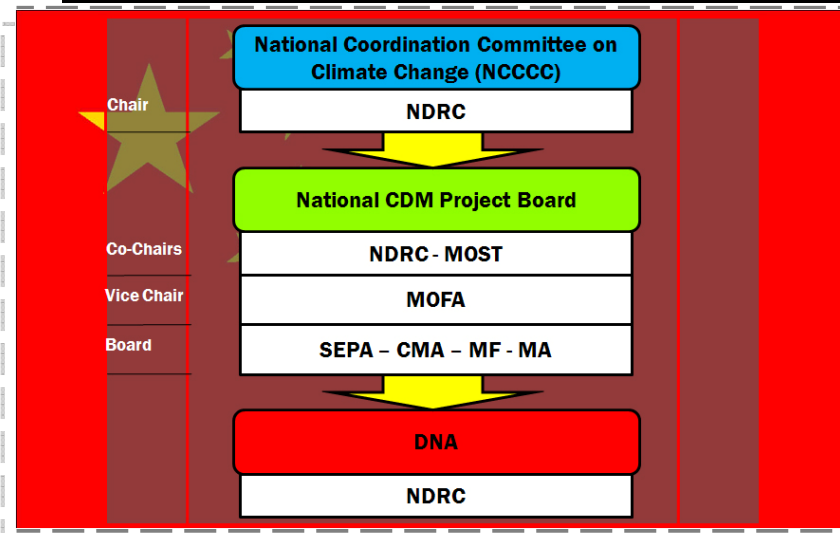
The governmental bodies responsible for the CDM activities in China are organized with a National Coordination Committee on Climate Change (the Committee) at the head of the structure, which is in charge of the review and coordination of CDM policies, rules and standards (art. 14 of the CDM Measures).

Under the Committee sits a National CDM Project Board (the Board). Its members are approved by the Committee, and its main responsibilities are to examine and approve CDM projects and to review the price of credits as indicated by the parties in the application form. Furthermore, the Board refers to the Committee about

The NDRC accepts the CDM project application and approves the project

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the overall progress of CDM project activities and makes recommendations on amendments to the CDM Measures (art. 15 of the CDM Measures).

The Designated National Authority appointed by China to manage CDM projects is the National Development and Reform Commission (NDRC). The NDRC approves every CDM project, evaluating its conformity with China's sustainable development policies, and serves as a chair of the Committee and a co-chair of the Board. It accepts CDM projects applications, issues the letter of approval and supervises the project's implementation.

In other words, the additionality assessment of a CDM project activity requires that, given the preliminary identification of the baseline scenario in the absence of the project, the project owner highlights the necessity of the project itself to achieve the desired GHG emissions reduction and explains why this reduction will not otherwise happen.

PROJECT PARTICIPANTS

According to art. 11 and art. 17 of the CDM Measures, foreign partners shall establish a CDM project in cooperation with a Chinese funded enterprise or Chinese holding enterprise acting as the project owner.

The ownership of a foreign party in a CDM project shall not exceed 49%. Consequently, the project owner can only be a Wholly China Owned Enterprise or a Joint Venture (JV) in which the Chinese party holds no less than 51% of the stake. Hong Kong and Macau enterprises are considered foreign investors and are not therefore eligible to act as project owners unless they constitute a JV in Chinese territory and the controlling stake belongs to the Chinese partner.

The revenues from the selling of the credits will be shared according to the percentage of the stakes held, less special taxes introduced by the CDM Measures and ordinary taxes as per PRC Enterprise Income Tax law. The figure below represents a basic investment structure, with the two cases in which the CERs purchaser is the foreign investor participating in the project or a third party.

TYPES OF PROJECTS

Art. 4 of the CDM Measures indicates energy efficiency improvement, development and utilization of new and renewable energy, and methane recovery and utilization as priority areas for the PRC projects. CDM projects related to these areas will be highly encouraged by the Government. Projects in other categories, such as industrial process changes, cogeneration, agriculture, transports and forestation / reforestation, are also encouraged.

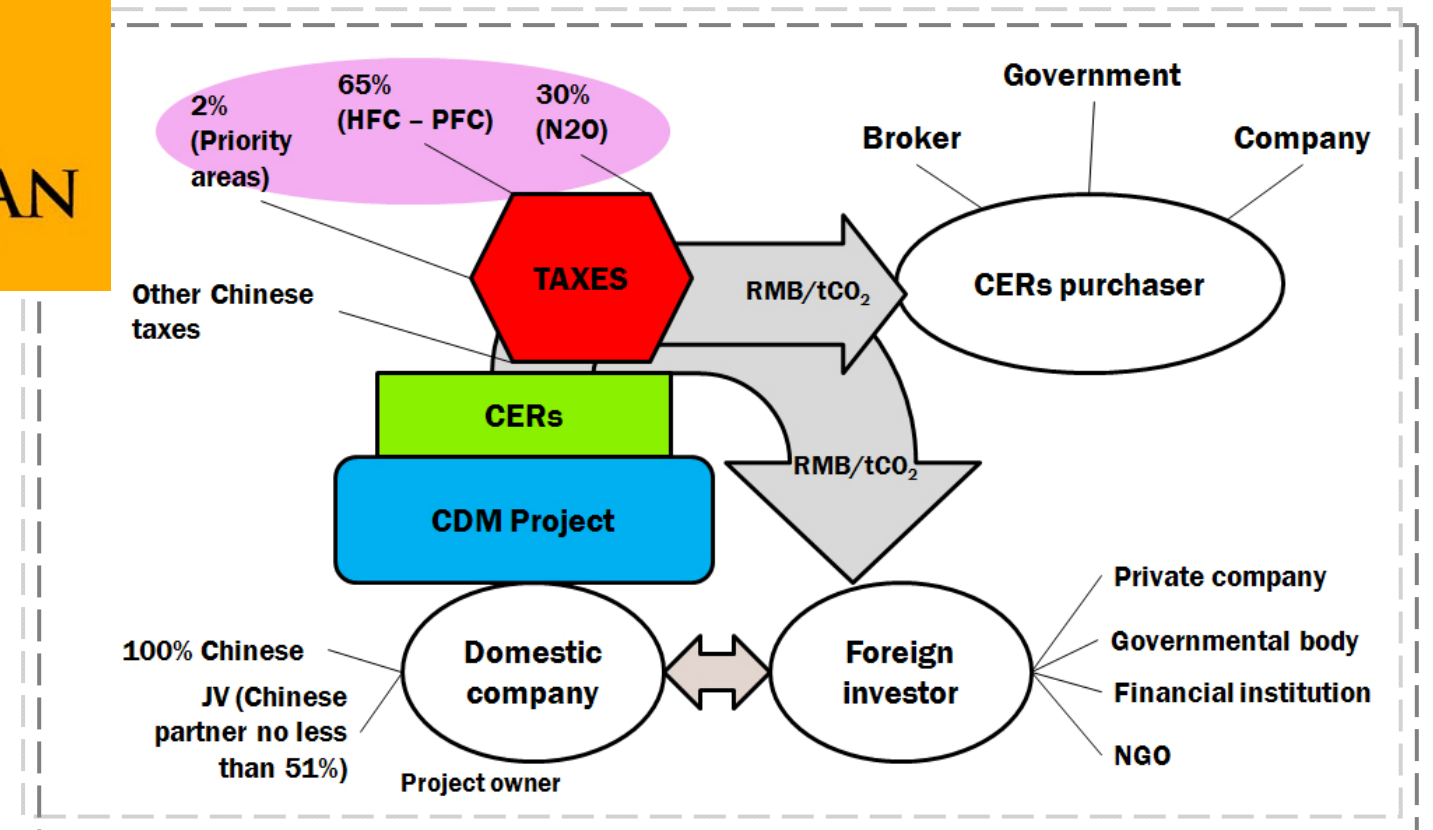
MAIN REQUIREMENTS

The rationale behind CDM projects is to contribute to the sustainable development of the hosting developing countries, so in order to grant the approval of a project the Authorities will examine its consistency with laws and regulations but also with PRC policies related to sustainable development and economic and social development (article 6 of the CDM Measures). For a CDM project to earn strong approval, its resulting effects should include factors such the alleviation of local poverty, the increase of local income and employment or the reduction of local environmental pollutants.

Furthermore, it is clearly stated that the project must not bring new obligations to China, other than the ones already introduced by the UNFCCC and its Kyoto Protocol (art. 8 of the CDM Measures) and that the implementation of a CDM project should promote the transfer of environmentally sound technology to China. The CDM activity must provide real, measurable and long-term emission reductions (as per art. 17.3 of the CDM Measures).

In addition to these requirements introduced at a national level, the project has to satisfy the "additionality requirement" introduced by the Marrakech Accords (and recalled in art. 17.3 of the CDM Measures). To qualify as a CDM project, and therefore produce carbon credits, the GHG emission reductions provided by the project must be additional to the so-called "business-as-usual" scenario, that is, to what would have occurred even in the absence of the project.

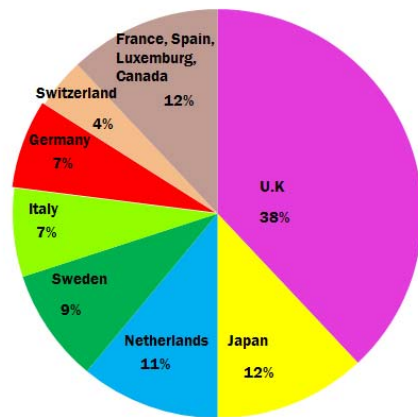
Laws, sustainable development and additionality



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Intended CERs buyers



TAX REGIME

Revenues generated from the selling of CERs are “jointly owned” by the project owner and the Government, as stated by art. 24 of the CDM Measures. The revenues collected by the Government from the transfer of the credits will constitute a special fund used to support activities on climate change.

The mechanism introduced by art. 24 essentially represents a taxation scheme on the proceeds of the project owner for the selling of CERs. This taxation rate varies according to the particular type of project implemented:

- 65% for HFC and PFC projects;
- 30% for N₂O projects;
- 2% for projects in the priority areas indicated by art. 4.

Taxation rate varies according to the type of the project

In addition to these special taxes, revenues from the transfer of the credits are subject to Chinese tax. Therefore, the new PRC Enterprise Income Tax Law will

apply.

The different allocation ratio scheme reflects the inclination of the Government to encourage the implementation of those CDM projects which contribute most substantially to sustainable development and best match priority areas set by the law. Projects in HFC and PFC categories produce a higher quantity of credits than projects in priority areas, but could lack additionality in respect to sustainable development aims and therefore be refused. Furthermore, HFC and PFC projects are subject to a much heavier taxation regime than other projects.

PRICING OF CREDITS

It is an international practice to let the price of carbon credits, as negotiable financial instruments, be freely determined by the demand-offer basic market principle and other factors such as risks in the implementation of the project and its performance.

However, the situation in China is different. Under Chinese law, the national CDM Board is responsible for reviewing the RMB/tCO₂ credits price as indicated by the parties in the application form. The price will be pre-determined by project developer and CERs buyer and reviewed by the Board for approval.

The price is predetermined by the parties

This mechanism allows the parties (and especially the Chinese government) to protect themselves from the risks connected to the fluctuation of the price. But pre-determining the price will certainly represent a disadvantage for the project participants if the market price would be higher after the credits were sold, or a disadvantage for the buyer in the opposite case.

These problems would clearly be solved if special exchanges for carbon credits are to be established in China, and it will probably happen in the very near future.

PROJECT CYCLE

1) drafting of the PIN

Even if it is not prescribed by the law, it is highly recommended that the project participants write down a preliminary Project Idea Note (PIN), a document that briefly provides information about location, type, size, and financial structure of the project. It should also contain information about the benefits for the environment and the sustainable development of the hosting country, as well as a preliminary assessment of the GHG emissions reductions to be achieved compared to the “business-as-usual” scenario. The PIN should then be submitted to potential credit buyers to obtain preliminary feedback about their interest in the project. In this way, it would be possible to get inexpensive market feedback without being involved in the entire approval procedure.

2) Drafting of the PDD

The next step will be the drafting of the Project Design Document (PDD), in which the project owner provides a detailed description of the project cycle. In this phase the project owner shall also invite local stakeholders to comment on the PDD. Subsequently, the project owner shall prepare a report containing a summary of the comments received and the methods used to address relevant concerns. This report has to be submitted for validation by the Designated Operational Entity (step 4).

3) Filing of the PDD to the NDRC for national approval

According to art. 18 of the CDM Measures, the PDD shall then be filed to the Designated National Authority (that for China is the National Development and Reform Commission – NDRC) for approval and subsequent procedures, enclosing the documents indicated in the art. 12 of the CDM Measures (certificate of enterprise status, general information about the project, description of the project financing).

The NDRC will entrust a commission of experts to gain an independent review of the project, to be concluded in 30 days, and will then submit the project application reviewed by the experts to the National CDM Project Board (the Board).

According to the decision of the Board, the NDRC will decide, within 20 days as of the date of the acceptance of the application (excluding the time necessary for the expert review), whether to approve the project or reject the application. In case of approval, the NDRC will issue a Letter of Approval to the project owner.

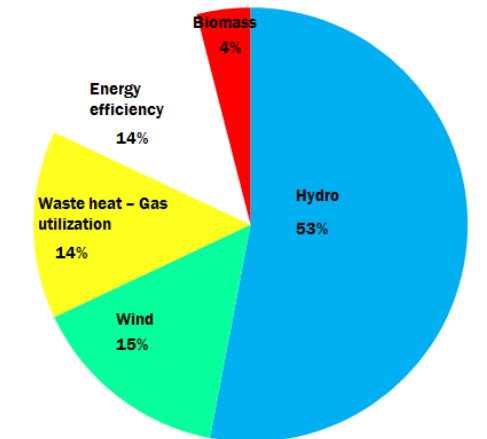
4) Validation of the CDM project by the DOE

The project owner should entrust a Designated Operational Entity (DOE) to conduct an independent review of the PDD and other relevant documents, enclosing the report about the stakeholders’ comments (step 2). The DOE will verify from various perspectives whether the project can qualify as CDM, and prepare a Validation Report that will be submitted by the DOE to the CDM Executive Board of the UNFCCC (the Executive Board) for the registration request.

5) International registration at the CDM Executive Board

Based on the Validation Report provided by the DOE, the Executive Board will decide whether or not to formally accept the

Projects types



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project application and register it, and will communicate its decision to the project owner. The project owner must then report to the NDRC the approval decision from the Executive Board within 10 days of receiving notification.

6) Implementation, monitoring and verification

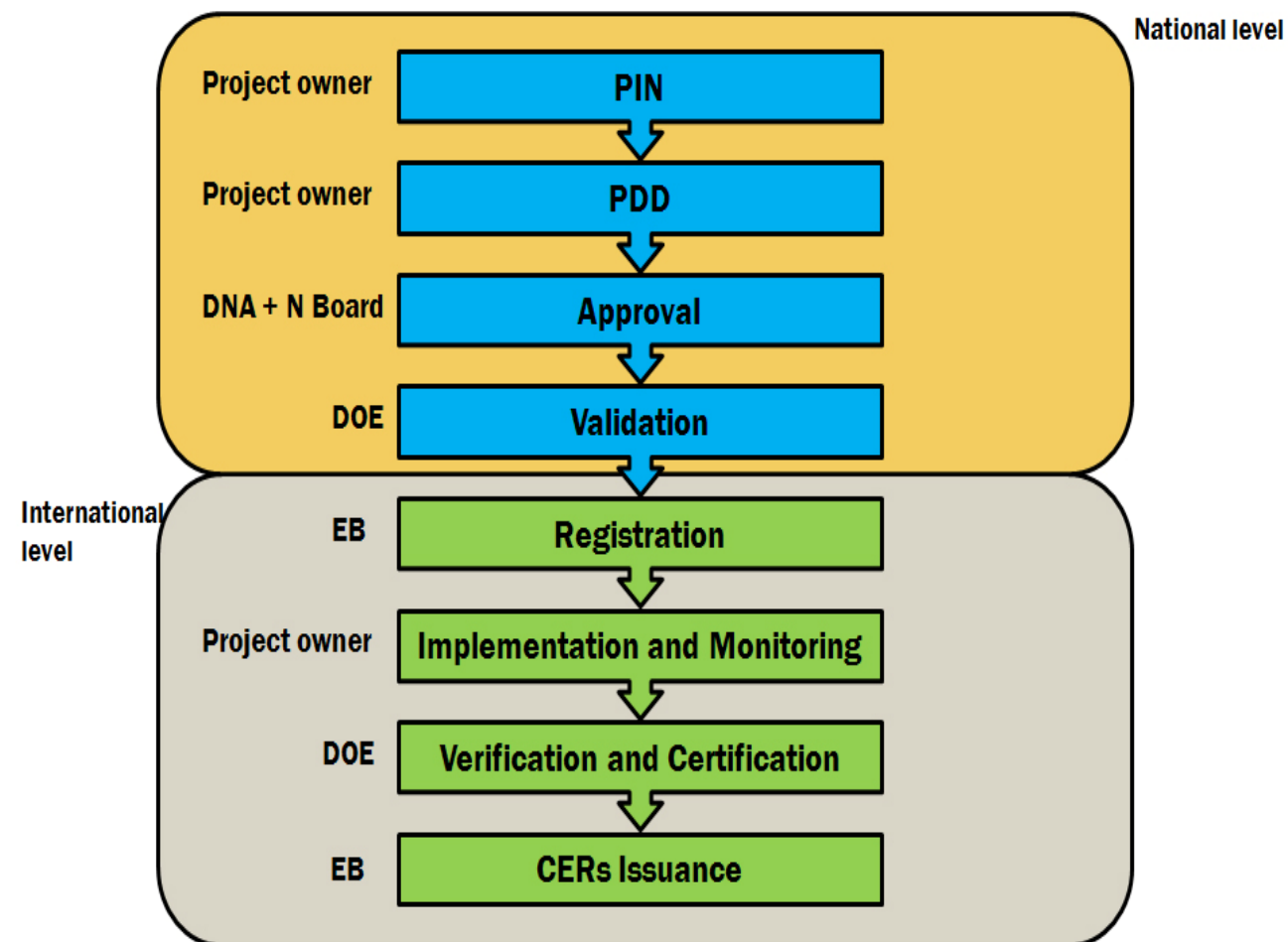
After having successfully obtained the registration from the Executive Board, the project owner should start to implement the project and monitor its progress in accordance with the monitoring plan included in the PDD. At this point the owner should entrust a new DOE different from the one entrusted for the approval and registration procedures.

During this phase, the project owner is required to prepare implementation and monitoring reports and to submit them to the NDRC and the DOE. The DOE is responsible for the verification of the Certified Emission Reductions (CERs) resulting from the CDM project. Eventually the DOE will issue a Verification Report and a Certification report to be submitted to the

Executive Board to confirm the amount of CERs and to ensure that the verified amount has been actually achieved.

7) issuance of credits by the Executive Board

According to the certified emission reductions provided by the project, the Executive Board will issue a correspondent amount of carbon credits and give notice to the project participants 15 days after having received the Verification and Certification reports (art. 20.3 of the CDM Measures). The CERs will be initially allocated into the account of the Executive Board, then, at the request of the participants, will be transferred to the relevant accounts. The NDRC or other organizations entrusted by the NDRC will put the credits issued by the Executive Board into file and record (art. 20.4 of the CDM Measures).



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