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An inconvenient truth for Beijing

China needs to be more flexible on carbon trading rules if it wants to benefit from Kyoto, writes **Corinna Yu** and **Daniel Levine**

Readers who have seen Al Gore's *An Inconvenient Truth* will have heard of the Kyoto Protocol's Clean Development Mechanism (CDM). It lets industrialised countries meet their emissions reduction obligations by funding projects in developing countries that are not bound by emissions targets.

Private companies funding such projects may also receive "certified emissions reduction" credits (CERs), which may then be sold to industrialised countries or traded on world carbon markets.

China, a signatory to the Kyoto Protocol, became the world's leading supplier of CERs in 2005, as investors speculating on the future value of carbon emissions credits sought to take advantage of its low marginal costs of carbon abatement.

Through so-called "project-based transactions," investors receive CERs when they fund projects that reduce greenhouse gases relative to "baseline" emissions levels. Foreign investors usually fund new projects, although in principle they can also receive CERs when investing in existing ones.

In a typical transaction, a Chinese project owner and its foreign partner will apply to the National Development and Reform Commission (NDRC) for approval for a prospective project. The application must specify, among other things, the project type, the methodology for calculating the baseline emissions levels, and the price per credit transferred in the transaction.

The project must be jointly approved by the NDRC, the Ministry of Science and Technology, and the Ministry of Foreign Affairs. Once a project is approved and operating, the project owner must, under the supervision of the NDRC, ensure that the emissions reductions are real, measurable and sustainable annually.

The landscape is slightly different when no foreign buyer has been determined when the project is submitted for approval. In that case, the CERs will be transferred to the state and can only be removed with the authorisation of NDRC.

The procedure has been successfully systematised, but nonetheless compromises the ability of foreign investors to make long-term, multi-project investments in emissions reduction technologies, particularly when lump-sum financing is required to cover all such projects at the outset.

Because approval can be granted only on a project-by-project basis, and because the government may withhold it until the price per CER is high enough, investors cannot assess the financial feasibility until approval is actually received, which may be many months after the initial funding.

Foreign investors would prefer the approval process to consider only the project's ability to reduce carbon emissions, with the price negotiation left to the investors and the Chinese project owners.

If China wishes to continue to capitalise on the benefits of the Kyoto Protocol, the NDRC and the other governmental approval agencies should be encouraged to approve and to accept more flexible financing and pricing mechanisms.

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