

KEY ISSUES FOR THE IMPLEMENTATION OF ENERGY PERFORMANCE CONTRACTING IN THE PRC

Background

It was reported in July 2010 that, according to new data from the International Energy Agency, China has passed the U.S. to become the world's biggest energy consumer. Although the data has been widely disputed by industry experts and energy agencies in China, it reflects China's recent surging appetite for energy as a result of its decades-long burst of economic growth. Added to that is the prevalence of energy waste as shown by the higher rate of energy usage per unit of GDP compared with other emerging economies and developed countries.

The Chinese government has been pushing through various energy-efficiency policies in recent years. One of these policies, initiated by the Chinese government with the support of the World Bank and the Global Environment Facility in 1998, is the promotion of energy performance contracting projects (**EPC**).

This short note briefly discusses the issues of how EPC works in China, the challenges facing this area and recent legislation and government policies.

How does EPC work in China?

EPC works in much the same way as it does in the developed markets. An energy service company (**ESCO**) will identify and evaluate energy-saving opportunities for a customer and then will recommend a package of improvements to be installed at the customer's premises. The ESCO will enter into an energy performance contract with the customer. The specific provisions of the energy performance contract will differ depending on the market and the leverage of the particular parties. The ESCO will usually provide, at its own cost, a wide range of services including project development, financing, design, engineering, procurement, construction and installation, training and maintenance. The customer and the ESCO will share the resulting utility bills' savings, through which the ESCO will recoup its costs and get returns on the investment. Once the ESCO has recovered its costs and received a reasonable level of return, the energy-saving equipment and improvements will be transferred to the customer free of charge.

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There are certain variations to the model depending on the specific situation of each case. An alternative structure would be for the customer to bear the costs (partially or wholly) for the installation of the energy-saving equipment and improvements. The ESCO guarantees a minimum level of utility savings, sufficient to cover the capital expenditure on an amortization basis and if agreed upon between the parties, a certain level of profit payable to the customer, with the remaining profit being shared by the ESCO. The ESCO will pay the difference if at any time the utility savings fall short of the guaranteed level. This latter model tends to be unpopular, as customers are reluctant to arrange the finance and bear the up-front fees of installation of the energy-saving equipment and improvements. A more simplified form is that the ESCOs will simply provide energy-saving related management services in consideration for service fees.

What are the roadblocks?

EPC appears to be a win-win model for the customer and the ESCO. However, despite the huge potential, it has been difficult to achieve the investments on the ground so far. Apart from the lack of corporate awareness, listed below are some of other challenges:

1. No easy access to financing for ESCOs. The ESCO will usually be required to pay the capital expenditure for equipment and improvements up-front. However, it is not easy for the ESCO, in particular small- or medium-sized ESCOs, to obtain bank finance. Hire-purchase and other alternative finance products for EPC projects are scarcely available in China.
2. Lack of protocol for the measurement and verification of savings and qualified third party reviewers. The measurement and verification of savings are central to determining the satisfactory performance of EPC contracts. The lack of standards similar to the International Performance Measurement and Verification Protocol and qualified independent engineers to review the energy-saving performance has hampered customers' enthusiasm to sponsor EPC projects.

3. Inefficient tax structure. The equipment and improvement, even if the titles will not be transferred to the customer until the expiration of the contract term, may be subject to 17% value-added tax. The tax authority may not distinguish the services and the equipment being provided by the ESCO but levy a blanket 17% value-added tax on the whole package, while if distinguished, the service would only be subject to 5% business tax.

Recent Regulatory Developments

In response to the challenges facing ESCOs, the central and local governments have recently issued various rules and policies. These include the *Opinions on the Acceleration of the Implementation of Energy Performance Contracting to Promote the Energy-saving Service Industries* issued by the NDRC, the Ministry of Finance, the People's Bank of China and the State Tax Bureau on 2 April 2010, the *Interim Measures concerning the Administration of Financial Incentives to Fund the Energy Performance Contracting* issued by the NDRC and the Ministry of Finance on 3 June 2010 and the *General Technical Rules of Energy Performance Contracting* issued by the Standard Administration of the PRC on 9 August 2010. In addition there have recently been various regulations and rules issued by local governments governing the provision of government grants and the regulation of independent reviewers for the measurement and verification of energy-saving. Highlights of these legislation and policies are as follows:

1. Banks and other financial institutions are encouraged to develop new financial products to meet ESCOs' financial needs. The procedures for EPC financing applications are to be simplified. ESCOs shall be allowed to use the fixed assets of an EPC project as collateral to apply for a mortgage loan.
2. ESCOs are exempted from the payment of business tax for revenue generated from EPC projects and from the payment of VAT on the free transfer of the EPC assets to customers.
3. ESCOs are exempted from income tax for three years starting from the first revenue-generating year and are entitled to 50% percent of the standard

income tax rate for the next three years.

4. All reasonable fees paid by the customer to the ESCO shall be treated as tax-deductible and the EPC project assets transferred by the ESCO to the customers shall not be treated as the ESCO's revenue.
5. The Standard Administration has set the standard for the measurement and verification of energy saving.
6. The energy savings of an EPC project must be measured and verified by a qualified independent reviewer in order to receive financial subsidies from the government. Qualified independent reviewers must be approved by the relevant energy-saving regulatory authorities.

The recent legislations and policies reflect the Chinese government's continuing efforts to promote energy efficiency projects. However, it remains to be seen in practice how the measures contemplated under the legislation and policies will be implemented, for instance, whether the banks will be enlightened to ease access to local financing for EPC projects. In addition, the standard for the measurement and verification of energy saving sadly seems to lack details.

This publication is intended to keep our clients and friends apprised of industry, regulatory and legislative changes that may have an impact on the way business is conducted and operated in China. It is for general information only, and is not a substitute for legal consultation.