Rewarding green efforts

Energy service companies are now privy to incentives and governmental support after Chinese authorities issue new policies that encourage businesses to become more environmentally-friendly

Energy-saving retrofitting of existing facilities in China will receive expanded official incentives and support under implementing rules expected to be issued soon by four major Chinese governmental institutions, in accordance with goals and policies recently outlined by the General Office of China's State Council. The rules will detail conditions under which Energy Service Companies (Escos) and their customers can enjoy clarified preferential benefits including income tax deductions, value-added tax (VAT) and Business Tax (BT) exemptions, government-encouraged financing, and direct government subsidies.

These benefits have been promised in the State Council's *Opinion on Accelerating the Implementation of Energy Management Contracting to Promote the Development of Energy Saving Service Industry* (the Opinion), or Guo Ban Fa [2010]No. 25 which was issued on April 2 2010. The Opinion provided for implementing rules to be issued by the National Development and Reform Commission (NDRC), the Ministry of Finance (MoF), the People's Bank of China (PBOC) and the State Administration of Taxation (SAT), all of which are also understood to have been involved in preparing the text of the Opinion.

Background

An Esco is notable for engaging in Energy Management Contracting (EMC), also known as Energy Performance Contracting, which entails contracting to reduce a customer's energy consumption in return for payments designed to be made from the customer's resulting expense reductions, thereby avoiding (at all times, but most significantly in the early stages of the project) any net increase in the customer's expenses or capital investments. This approach can induce customers to contract for energy-reduction projects that they would otherwise have rejected because of real or imagined financial and/or technical risks.

In 1998, China's first three officially recognised Escos were established in Beijing, Liaoning and Shandong by the China Energy Conservation Project, and backed by the International Finance Corporation and the Global Environment Facility. By 2009, the number of such Escos had grown to 502, the number of their contracted projects had grown to 4,000, and the value of these projects had grown to Rmb 28 billion.

But it has become widely recognised that in order to continue and guide the expansion of Esco activities, the central government must address the following major obstacles:

- unclear accounting treatment;
- tax disincentives; and
- incompatibility with existing financing models.

The Opinion specifies a number of tax clarifications and preferences for Escos and their customers

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General goals & stages

The Opinion addresses the above obstacles by specifying general goals as a framework for the customary issuance of detailed implementing rules. In article 2, the general goals are grouped into the following two phases:

- The first phase goals are to support both specialised and large-scale Escos in order to establish a more active energy service market by 2012.
- The second phase goals are to improve related mechanisms, to further expand the size and number of Escos, and to make EMC one of the major models for China energy-consumption retrofitting by 2015.

Size matters

Under one's first impression, the Opinion's emphasis on large-scale Escos may appear to reflect China's occasional excessive preference for large-scale domestically-owned companies, rather than a tailoring of policies to this particular emerging industry. But in fact, large-scale Escos are necessary because they are most likely to have the following important attributes:

- The technical ability to implement and/or coordinate simultaneous retrofitting of multiple aspects of a facility's energy consumption (such as fuel selection, on-site power generation, insulation, wiring, piping, and power and water consuming and distributing equipment upgrading).
- The depth and breadth of personnel to enable timely and integrated retrofitting of large facilities, or collections of smaller facilities (such as larger, and/or groupings of smaller, industrial, residential, offices, commercial, or leisure facilities).
- The size and financial sophistication, and credibility to package EMC-based assets, accounts receivable and other rights and projected revenues into financial instruments that are acceptable to conservative (low-return) lenders and/or investors.

Tax policies to be detailed

The Opinion specifies a number of tax clarifications and preferences for Escos and their customers, relating to enterprise income tax (EIT), VAT and BT. VAT and BT preferences are a welcome broadening of the EIT preferences that were previously available in the renewal energy sector.

Esco Tax Benefits

Firstly, an Esco's gross revenues derived from an EMC project will be exempted from both BT (which is applicable to most services) and VAT (which is applicable to most goods) during a "temporary" period, which remains to be defined by implementing rules (to be issued by the SAT). Despite the current uncertainty about the definition of this period, this exemption is expected to be very valuable for Escos. Reasons for this value go beyond the tendency (faced by all service companies) for BT's non-creditable (and consequently cumulative) structure to deter customers from purchasing services to meet any need that can be satisfied through a purchase of goods. Another tendency has been for the combination of goods and services typically provided by an Esco to result in confusion about which payments under its contracts are subject to BT and which are subject to VAT. Moreover, the difference between the 3% rate of BT applicable to construction, installation or transportation service revenues, and the 5% rate of BT applicable to design or consulting service revenues, has resulted not only in confusion but also in over-taxation because the tax authorities are entitled to apply the highest rate to revenues that the taxpayer cannot prove are allocable to a lower-rate category of services.

Secondly, an Esco's net income derived from an EMC project will be exempt from EIT for a period of three years, and will be reduced by 50% during the subsequent three years. This exemption will result from an Escos' eligibility, newly clarified by the Opinion, for a pre-existing incentive, which had been specified in the EIT Law (Article 27), and in the EIT Law Implementing Regulations (Article 88).

Thirdly, an Esco's transfer to a customer of equipment or other asset ownership at the end of an EMC project, if completed (as is customary) "free of charge", will not result in the Esco being forced to recognise directly any revenues or income. Previously, tax authorities had the power to insist on recognition of deemed income.

Criteria for an Esco to become eligible for the above incentives are not specified in the Opinion. A likely indication of the eventual criteria can be found in a late-2009 tax circular on criteria for eligibility of Escos for previously available EIT incentives (Caishui [2009] No. 166, issued by the SAT on December 31 2009.) Key criteria specified in that circular include minimum registered capital of Rmb 1 million, and demonstration of certain technical capabilities required by provincial governments.

Customer Tax Benefits

Customers of Escos will also enjoy corresponding benefits. The above asset transfers will not impose any mandatory accounting or tax detriments on customers, who will be permitted to treat the transferred assets as fully amortised or depreciated. The most immediate tax benefit to customers will be the right to treat, as currently deductible expenses, the full amount of payments to an Esco under an EMC, rather than requiring the allocation of any portion of such payments to (depreciable or amortisable) capital investment.

Government agencies and public institutions, which would be particularly suitable customers of EMC projects if not for deterrents resulting from the current public finance management system, will benefit from clarified and preferential accounting changes. These customers will be permitted to treat payments under an EMC as "energy expenses" and to treat their receipt of assets under such an EMC as receipt of "donations".

Subsidies & financing to be detailed

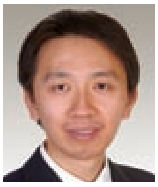
The Opinion also points towards increasing direct support from various levels of government. Financial subsidies are specified to be forthcoming, to qualified EMC projects, from the central government budgets for general investment and for energy saving and emission reduction projects. Local governments are encouraged to arrange for certain funds to support the EMC projects "if conditions permit".

The Opinion also encourages banks and other financial institutions to support Escos by creating more innovative credit products, broadening the scope of loan collateral (to include EMC-created or EMC-transferred fixed assets), and streamlining application and approval procedures for related project financing, factoring and other financial services. Foreign preferential loans and grants are also specified to be welcome in this sector.

More changes to come?

The experience of Escos in foreign markets indicates that additional systemic changes may be necessary in order for EMC to approach its full potential for conservation and efficiency. Potential additional changes include the following:

- Using utility-providers and their collections procedures as a channel for financing, and for delivery of subsidies and other financial incentives.
- Creating leasing-focused incentives, in order to increase cooperation among stakeholders that have conflicting interests, for example in situations where property tenants bear current energy expenses, while owners would bear the expense of retrofitting.
- Linking property tax preferences, based on energy conservation, to property itself, regardless of changes in ownership, in order to encourage participation by property owners who may not retain ownership throughout the payback period of retrofitting.
- Requiring or encouraging energy audits in connection with property sale and/or financing transactions.
- Arranging guarantees (for example, by state-owned banks) or other support for tradable securities based on energy savings and/or EMC revenues.
- Conditioning other preferences, such as those for usage (and/or generation) of renewable energy, upon coordinated retrofitting of multiple aspects of a facility's energy consumption.



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In seeking to integrate renewable energy equipment manufacturing with services-based conservation, China can benefit from Chinese manufacturers' large production capacity, strong desire to increase sales, and demonstrated willingness to go 'downstream' to do so, along with Chinese utility operators' demonstrated appetite for broadening their profit-generating activities.

The prospects for Escos and EMC in China to gain sustained government support, private investment, expansion and profitability appear particularly bright because of the intersection of several underlying economic and policy trends. Escos and EMC will both benefit from and contribute to China's movement to increase energy conservation, to further localise the generation of renewable energy, and to shift more of its workforce and economic activity from commoditised manufacturing into higher-value services.

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