

# Reflections

Volume 4 Edition 2

## Adapting to the “new normal” environment Business Take-Aways

### Inside this issue:

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- China is ramping up its environmental remediation and protection standards. This will:
  - raise regulatory risk, compliance and operational costs
  - accelerate automation in coastal provinces and
  - press for the relocation to the interior of many manufacturing plants
- Re-regulation will create opportunities for innovation, especially cleantech. There will be high growth in certain sectors and geographies.
- Due to China's use of Best Available Techniques (BAT), regulatory upgrading will be phased, extending over time, probably the next 10-20 years.
- The current political focus is on combating air pollution, particularly given the conditions in northeast cities. This priority will then shift to remediating water and land / soil pollution.
- With the increasing importance of consumption and services, the focus will shift from emissions to prescriptive policies for management of waste streams, packaging, recycling and climate change. Complete supply and value chains will be under scrutiny.
- In coming years, financial instruments will be introduced, such as carbon trading and environmental taxes. Public Private Partnerships (PPP) are planned for renewable energy, water treatment, public transport and solid waste treatment.
- Environmental standards will become a battleground in China and internationally. The US and EU will vie to influence China's standard setting. Concurrently, China is seeking greater influence in setting international standards.
- Companies' activities will be under closer scrutiny by local communities and civil society organizations (CSO). Public interest legal actions are now allowed and will multiply.
- Companies will be required to restructure their operations and reassess resourcing of functions to accommodate the environment of the “new normal.”

### Contact Us

#### John Russell

Managing Director

[jrussell@northheadcomms.com](mailto:jrussell@northheadcomms.com)

+86 10 8591 0986

#### Jiang Xiaofeng

(Shawn)

Executive Director

[xfjiang@northheadcomms.com](mailto:xfjiang@northheadcomms.com)

+86 10 8591 0056 288

Efforts to clean up the environment and create a ‘beautiful China’ are political priorities. Reforms that shift China's growth model towards sustainable economic development are undoubtedly creating opportunities for business. This will generate demand for energy-efficient and emissions-reducing technologies which are slated for being engines of future growth.

**“We will declare war on pollution as we declared war on poverty”,**

Premier Li Keqiang, March 2014

But there are challenges. The Eastern provinces, especially their large cities, are aspiring to evolve rapidly to post-industrial economies. This entails the restructuring of local economies, large scale factory closures with significant job losses and the dislocation of local employment patterns.

These reforms are being undertaken against the backdrop of slowing growth, the “new normal.”

The pace of change places stress on companies to adapt to the changing regulatory and market conditions. There will be winners and losers. This issue of Reflections reviews the growing drum-beat of environment regulations and seeks to predict trends and their impact on those doing business in China.



Apps: a “breath of fresh air” for monitoring

## State of the environment



NOT In My Back HUTONG!

The Supreme People's Court has established an environmental tribunal to streamline litigation and deal with the growing number of complex environmental cases. Over 130 local environmental courts have been established.

### Civil Society

With the easing of Civil Society Organization (CSO) / NGO registration requirements, a burgeoning non-profit sector is slated for a more active role monitoring the enforcement of pollution prevention and remediation. At the start of 2015, courts heard the first slew of environmental public interest lawsuits brought by newly empowered domestic NGOs. Local environmental protection bureaus and other organizations such as the Alibaba Foundation are supporting capacity building of NGOs for such cases.

### China's environmental woes

#### Air

- In 2013, according to the Asian Development Bank, seven of the ten world's most air-polluted cities were in China.
- Just three of China's 74 largest cities met the Ministry of Environmental Protection's air quality standards.

#### Water

- 44% of drinking water in rural areas fails to meet national standards.
- 270 million people in China do not have access to clean drinking water.
- One third of rivers are seriously polluted.

#### Soil

- 3 million acres of China's arable land are contaminated - almost one fifth of the total.
- Total clean up costs could eventually reach USD 1.6 trillion
- 12 million tons of heavy-metal contaminated grain are produced each year, with an economic cost of over USD 3.2 billion.

### Some drivers and enablers

#### Populism and Legitimacy

The battle against pollution reflects growing demands for quality of life and heightened environmental concerns of the public, especially urban middle classes. Over the past few years there have been a series of popular protests in various cities against major industrial projects. With greater public sensitivity and protests the leadership has prioritized environment protection on the policy agenda. The air pollution in the northeast has been acute and the party leadership has resolved to address it robustly.

#### Rule of Law

In October 2014, the Fourth Plenum of the 18th Central Committee approved increased use of rules-based mechanisms to improve governance and strengthen party rule. Thereby, central and local government officials should be more responsive to public concerns. Environment protection and quality of life are high priorities.

With the revised Environmental Protection Law, fines for polluters will now accumulate daily as violations continue. The law has abolished previous caps on fines and established a legal basis for future environmental taxes.

**"A clean environment is a key component of the China Dream"**

-President Xi at the APEC summit, Beijing November 2014.

There has been a quickening drumbeat of new legislation. During 2014 MEP released four new regulations each month on average.

Environmental legislation is progressively intruding into the full gamut of business operations along the value chain from sourcing, manufacturing, logistics to packaging, recycling and waste management. Some changes for key sectors follow.

The upcoming 13th Five-year Plan 2016-2020 is set to give even greater priority to environmental remediation.

## Greening the supply chain

### Energy



China is increasing natural gas imports as part of the shift from coal to cleaner fuels. The government aims for gas to account for 10% of China's energy mix by 2020, up from 5.9%

in 2013. In 2014, China signed a USD 400 billion deal to import gas from Russia.

The Silk Road Economic Belt initiative increases access to supplies from Central Asia, reducing energy dependency on the Middle East. Pipelines from Central Asia are being expanded, the capacity of the China-Myanmar gas pipeline will increase, and there are proposals to build an oil pipeline from Gwadar, Pakistan, to Xinjiang.

By 2020, China plans to generate 15% of

energy output from renewable sources, up from 9.8% in 2013. By 2015 100 million KW of wind energy and 35 million KW of solar energy will be produced annually.

The 2014-2015 Energy Conservation and Emissions Reduction Action Plan establishes a national Demand Supply Management platform and reduces preferential electricity pricing for energy intensive industries.

### Manufacturing



#### Air

The new Air Pollution Prevention and Control Law will introduce harsher punishments for pollution. Local officials

will be assessed on compliance with air quality targets and local governments given more power to set standards that are stricter than national regulations.

Emissions trading systems covering ammonia, sulfur dioxide and nitrous oxide are being piloted in 11 areas across China.

Factories in urban areas will come under increasing pressure to reduce emissions or relocate.

#### Water

The State Council is to release an action plan for water pollution prevention. The draft plan earmarks USD 320 billion for reducing water pollution, improving

drinking water safety and cleaning up lakes and rivers. There are likely to be increased market opportunities for companies offering waste-water treatment services and technologies.

In July 2014, it was announced that water rights trading schemes would be trialed in seven provinces. These are precursors for a nation-wide scheme. As for carbon trading pilots, provincial governments will issue water rights, allowing recipients to sell unused allocations.

### Transport



Six million cars that do not meet current emissions standards will be removed from the roads.

China will continue to ramp up fuel and vehicle emissions standards. In 2015, Beijing municipality will release the first China VI emissions standards for light vehicles. There is a switch to

using US standards as a guideline when formulating China VI. In the past, EU emissions standards have been used as the benchmark.

Traffic regulations will be tightened. Large trucks are now prohibited from central Beijing from 0600-2300hrs, impacting deliveries. Other cities are following suit.

New energy vehicles (NEV) are a priority for

stimulating innovation, accelerating carbon emissions reduction and combating pollution. From September 2014, NEV are exempt from the 10% purchase tax. The tax waiver should stimulate demand for NEV, but consumer concerns on convenience and reliability will remain.

### Fast Moving Consumer Goods



Beijing, Shanghai and Guangzhou have published regulations on excessive packaging. Producers are required to minimize packaging and use recyclable materials. Rules are set for the number of layers of packaging, ratio of packaging to product cost, and volume of packaging.

As China shifts its economic focus to consumption and services, more prescriptive regulations related to packaging, waste management and disposal, eco-labelling and recycling can be expected.



Opportunities abound in recycling

## Trends and predictions

Currently, air pollution is the "hot button" political issue. Once regulations are in place, expect a shift of focus to water and then soil remediation.

If European and North American experiences can be taken as guides, an evolution from overarching framework legislation to detailed, prescriptive environmental regulations can be expected.

Anticipate a shift to "integrative" regulations, including integrated product policy (IPP), integrated pollution and prevention control (IPPC), eco-management and audit scheme (EMAS) for production facilities and energy using products (EUP).

China's adherence to Best Available Techniques (BAT) rather than Environmental Quality Standards (EQS) will extend the duration of change over many years.

### Financial instruments

Expect more financial instruments, possibly resource taxes, stricter and broader interpretation of environmental liability and more frequent enforcement of the precautionary principle.

National carbon trading: Phase 1 will be launched in 2016 for six sectors, including



The winds of change are blowing

petroleum, chemicals and aviation. Phase 2 will start in 2019, covering more sectors and tradable products.

There will be linkages with international carbon markets. A carbon tax will be introduced for smaller scale enterprises. These policy initiatives will generate demand for energy efficient technologies.

There will be increased use of market mechanisms. Emissions trading schemes for atmospheric and water-borne emissions will be gradually rolled out at the national level.

### Public private partnerships (PPP)

Investment is encouraged in areas including sewage treatment, third-party environmental services and investments for reducing emissions. Subsidized loans are the prime incentive.

### Support for third-party environmental service providers

China has a shortage of third-party service providers helping polluting enterprises meet environmental standards. A USD 8 billion fund has been established to provide preferential loans for service companies.

## Business implications

- Manufacturing facilities that produce emissions are under increasing pressure to relocate from the largest cities. Beijing has earmarked 300 polluting enterprises to leave, while funds are in place to encourage others to upgrade their operational processes. Shanghai and others are adopting similar programs.
- The future of many legacy plants and facilities around cities of eastern provinces will be under question.
- Other sectors will flourish, for example environmental services and robotics. New industries will emerge, such as the export of used automobiles to central and Southeast Asia, with iterative tightening of China's vehicle standards.
- Regulators and authorities will become more intrusive of business operations along the value chain, from sourcing, production, distribution to end-of-life disposal.
- External stakeholder relations will be more complex. Additional resources will be expended on community relations and CSR.
- Industry associations will become more important, especially for advocacy. As regulations become detailed, interests of different industry sectors will diverge and compete with each other, based on where liability and costs of compliance fall.

### About Us

North Head is a strategic communications and public affairs consultancy that tracks developments related to environmental protection in China. To receive future issues of China Reflections or obtain more information and analysis of changes China's environmental policy and regulatory landscape, please send an email to [info@northheadcomms.com](mailto:info@northheadcomms.com)



Strategic Counselor



Shenzhen

Strategic Counselor



Scan the QR code to download our iOS app, "Portal to China"

2805 Full Tower,  
No. 9 Dong San Huan Middle Road,  
Chaoyang District, Beijing  
100020  
Phone: +86 10 8591 0056

E-mail: [info@northheadcomms.com](mailto:info@northheadcomms.com)

[www.northhead.com](http://www.northhead.com)