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PART B: DETAILED QUESTIONS FOR RESPONSE

1. Among the most heavily traded compliance-driven emissions credits trading worldwide such as Assigned Allowance Units (AAUs), EU emission allowance (EUAs) and Certified Emission Reductions (CERs), only CERs are likely to originate from the Asian region [1] with an international investor demand. Hence, we believe the pilot product to be launched in the emissions-futures space should be Euro-denominated CERs. We have conviction in its significance in the world carbon market due to the following reasons:

(i) Copenhagen Summit

As our recent study of global outlook for climate change policies reveals, despite recent policies adopted by various administrations in the world, the European Union (EU) has led climate change initiatives and therefore going forward, would set standards for the rest of the world in GHG reduction mechanisms.

In the European Union Emissions Trading Scheme (EU ETS), CERs are the second most popular commodity after EUAs, and the only offset limits that are likely to originate from the Asian region. We are convinced that demand for CERs to offset emissions would increase as European countries tighten their targets going into Phase III of EU ETS and potentially other emerging schemes would use CERs as a complement to their domestic offset credits.

(ii) Timeframe

We believe any emerging trading schemes such as a possible US trading scheme or the pending Carbon Pollution Reduction Scheme (CPRS) in Australia would begin trading domestically and likely incorporate international credits such as CERs in their respective initial phase. Consequently, we advocate that CERs be the core carbon emission product to pursue in Hong Kong now. China is the largest host to CDM projects and hence the largest supplier of CERs, if Hong Kong authorities can argue for the case of secondary trading in Hong Kong, Hong Kong can be strategically situated to be a regional hub for emissions trading and this paves way for a market for Asian countries having to conform to emissions target in the medium term.

In the next few years, however, other alternatives will have to be considered if CERs prove successful since all "low-hanging fruit" projects would have been implemented and approved through the CDM Executive Board. These alternatives would include Emission Reduction Units (ERUs) generated through Joint Implementation (JI) and voluntary carbon credits such as Gold Standard as more corporations seek to reduce their carbon footprints.

[1] *Since the both Japan and Australia have yet to catch up with their emission targets and hence have to purchase instead of sell carbon credits.*

2. Looking at the European Climate Exchange as a successful role model for launching CER futures, strong pipelines of Clean Development Mechanism (CDM) or Joint Implementations (JI), keen investor demand interest and technical know-how investing in CDM projects in China is vital in establishing an active CER market.

(i) CDM project pipeline

China hosts the greatest number of CDM projects[2] (with a lion share of 84%), Hong Kong is favorably situated (geographically and economically) to take advantage the potentially numerous CDM projects that take place in the Mainland. That said, significant political hurdles would have to be overcome so that Chinese authorities allow secondary trading of carbon credits in Hong Kong.

(ii) Investor presence and project management know-how

Since Japan is the only country that has ratified the Kyoto protocol and it is not likely that other Asian countries would need to meet emission targets, at least within the next compliance timeframe. A potential Hong Kong market needs to attract international investors.

In particular, international investors who have to conform to the standards would be interested in investing in CDM projects in China. As a regional hub, an exchange might need to be a primary buyer in CERs generated through CDM projects as its status allows it to favourably do so. As such, an exchange can engage consultancies with vast experiences in CDM/ JI project management to help mainland enterprises establish CDM projects in China and hence purchase CERs on a forward basis. Such CERs can then be resold in the secondary market. A futures exchange can effectively add value by acting as a bridge between international buyers and mainland developers by providing expertise and maintaining price integrity. Such mechanism might only be required in the pioneer phase of the exchange when liquidity is limited.

3. Hong Kong has a mature equity futures market yet an under-developed commodity futures market. Despite the fact that, carbon trading has been gaining popularity worldwide, the Hong Kong investing community in generally has yet to be educated well to understand the risk/ return profile, fundamental drivers of CER product prices and the international trading mechanisms.

Moreover, CERs, intuitively thought to be a diversification investment (and hence low-beta), could and did witness considerable volatility along with the financial turmoil.[3]

Consequently, we believe that the pioneer investors will be limited to financial intermediaries and corporations aiming at offsetting emissions in the initial phase. General public consultation and corporate education will need to be heightened before a carbon futures product is launched.

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[2] http://www.cdmpipeline.org/cdm-projects-region.htm

[3] *Source: European Climate Exchange* http://www.ecx.eu/CER-Futures

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4. Not Applicable

5. We believe two potential issues remain: development of climate exchanges in China and the potential market for voluntary credits:

(i) Chinese climate exchanges

An important issue would inevitably be the development of climate exchanges in mainland China. It was mentioned in the Consultation Paper that Beijing, Shanghai and Tianjin authorities have set up exchanges specifically for the purpose. On top of that, smaller, provincial trading programs have already kicked off.[4] The ability of the Hong Kong Exchange to collaborate with these exchanges and to capitalize on the popular international carbon credit unit (i.e. CER) to standardize trade units in mainland China (and potentially the Asian region) would be crucial. Such efforts may entail constructing a unified log system similar to the Community Independent Transaction Log (CITL) under EU ETS for CDMs for the Asian region.

(ii) Potential for voluntary credits

The Consultation Paper presumes the launch of CERs as the only pioneer product shall there be an emission futures market in Hong Kong. An alternative approach could be to develop a voluntary carbon market first. As the Asian region is unlikely to be required to meet legally-binding emission standards soon, a voluntary market could potentially provide transparency, price stability and bridge buyers and sellers in the international voluntary market. Since there is currently a lack of common verification standards for voluntary credits, a Hong Kong voluntary carbon exchange can add value by unifying verification requirements, setting a credible price for voluntary credits and hence provide assurance to companies (and their stakeholders) in their use of voluntary credits to reduce carbon footprint.

6. We believe in this stage of the development process, it would be beneficial to engage major players, including but not limited to, major energy/utility and transport corporations, financial intermediaries, climate change management consultancies, Mainland exchanges and authorities. This would enable a road map be drawn with considerations of all stakeholders involved.

[4] *For example, a pilot sulphur dioxide emissions trading program was initiated in 2002.*