PART B: DETAILED QUESTIONS FOR RESPONSE

Please indicate your preference by providing comments as appropriate. Where there is insufficient space, please attach additional pages as necessary.

(1) The first commitment period of the Kyoto Protocol will expire in 2012. The continuity of CERs as recognized carbon emission offsetting credits under the Kyoto Protocol is subject to a new international framework for the second commitment period under negotiation with a target completion in the United Nations Climate Change Conference in Copenhagen in December this year. Meanwhile, the US appears to be committed to develop a US emission trading scheme, but the details of the scheme are subject to further announcement and the relevance of CERs is uncertain. Against this background, do you think CERs should be the core carbon emission product to pursue in Hong Kong now or in a few years' time?

See attached file

(2) At this stage, the global CER market is dominated by European participants connected to the EU ETS and the delivery of CERs is based on the EU standard. Mainland China is the major supplier of CERs, which focuses on clean development projects and CER origination. Under Mainland China's policy, CERs are usually engaged by foreign investors based on forward sale agreements before they are issued by the United Nations. As such, the secondary CER trading market is not developed. European participants are using CER markets in Europe to manage their carbon emission trading needs and risk exposure. Under the existing market conditions, in what way can Hong Kong add value to the business process of the CER market and attract carbon emission trading participants to the Hong Kong marketplace? What are the success factors for Hong Kong to develop a commercially viable CER trading platform that can attract trading activities and develop trading liquidity? Do you think Hong Kong possesses the success factors? Please explain your view.

See attached file

(3) Do you consider Hong Kong investing communities have sufficient knowledge in carbon emission trading and are they ready to participate in trading CERs products? Please explain your view.

A successful initiative for HKEx has to plan for intensive and extensive road shows including training sessions with existing market operators.

(4) If you are a financial intermediary, please respond to the following questions:

(i) Do you see any potential in the asset class of carbon emissions and how would you rank the priority of carbon emission trading business among your other business initiatives? (high, medium or low)?

Société Générale, one of Orbeo's parent companies, has demonstrated early commitments in the carbon markets, through the involvement in the European Carbon Fund starting in 2004, the establishment of a carbon trading desk in 2005 and the creation of Orbeo with Rhodia in 2006. Carbon emissions asset class is a high priority for both mother companies, as is demonstrated in the recent purchase of carbon projects developer One Carbon.

(ii) How would you assess your clients' interest in carbon emission trading? Do you have the know-how and expertise in handling carbon emission trading related operations and providing advisory services to your clients?

Orbeo trades all the carbon underlyings. We have both know how and expertise and are able to provide advisory services to our clients.

(iii) Are you located in Hong Kong and if so are you an Exchange Participant of Hong Kong Futures Exchange?

Our mother company Société Générale is an active commodity financial products seller in Hong Kong. We have offices in Hong Kong.

(5) Are there any other issues regarding the introduction of CER futures not mentioned in this consultation paper that we ought to consider? Please explain your view.

No further comments

(6) Do you have any other comments in relation to the overall development of emissions or pollutants trading markets in Hong Kong?

No further comments

- End -

Answers Question 1 and 2

QUESTION 1

At Orbeo, we believe CERs will remain one of the key carbon products for emission reductions in developing countries after 2012.

Recent progress in legislation and international negotiations has shed some light on the status of CERs in the post-2012 period in Europe, under the next UNFCCC framework, and in the United States.

In December 2008, the European Parliament passed a new Directive revising the EU ETS for the post-2012 period. The Directive guarantees that CERs are recognized as a compliance instrument after 2012 in the EU energy-climate package, both on the EU ETS market, and at EU States level. For the 2008-2020 period, demand in the EU plus Norway zone is estimated at 1750 Mt for the EU ETS and 1500 Mt for the EU and Norway governments, itself split into 500 Mt pre-2012 (budgeted / announced) and 1000 Mt (central estimate according to Phase III rules) post-2012. The restrictions on the types of the CERs are the same as in the EU ETS phase II. However, although there is no mention of “high quality” credits in the articles of the Directive, it is envisaged by the European Union to pass strict restrictions on the “high quality” of the CER, i.e., their sustainable development dimension. In any cases, such restrictions won’t pass before 2014.

At the UN level, the preparatory negotiations to a post-2012 agreement include discussions on the mitigation mechanisms to be implemented by developing countries. Criticisms have been raised against the CDM, from both Annex I and non-Annex I parties. However, most developed countries and a wide number of developing countries favor an offset mechanism that would incentivize the private sector to fund the most cost efficient mitigation actions in developing countries, even if it has to be improved and complemented. The “legacy” of the CDM present pipeline means that a large share of the identified emission reduction potential in developing countries have been formalized in CDM Project Design Documents, which results in this mechanism having to survive for at least a several years transition period.

The Waxman-Markey bill recently passed through the House of Representatives in the United States. The bill implements a federal cap-and-trade system in the United States. Under the House version of the legislation, international offsets can be used for compliance up to a limit of 1 billion tons per year, although it can rise to 1.5 billion tons per year if the supply of domestic offsets is below 0.9 billion tons. Our estimates set the expected US demand for international offsets at 715 million tons per year. According to the bill, eligible offset must be originated in a country which has entered a bilateral or multilateral agreement with the United States. If the United States, as expected, ratifies the next international agreement, then all CERs will be accepted for compliance, as they will be originated in countries that have ratified the treaty too.

QUESTION 2

We believe that under the current market conditions there could be impediments to the development of the market on the supply-side, though not on the demand-side.

As stated above, we expect a wide eligibility of CERs in compliance schemes. European experience shows that compliant buyers are interested in purchasing guaranteed CER contracts on exchanges when and where possible, as an alternative to primary CERs, for risk management reasons. European compliant buyers are large industrials which often have trading experience in Asia and would easily turn to the Hong Kong secondary market for CERs, at prices equal or below those on the EU ETS.

The two intrinsically related supply-side factors today jeopardizing the development of a Hong-Kong based secondary market are the stringency of the Chinese NDRC policy to date and the difficulties of attracting local financial institutions in the secondary emissions markets.

China is by far the world's largest supplier of CERs, with an 84 percent share of the primary CER market in volume in 2008, and a 91 percent share of the primary Asian supply. China is also the country with the most stringent regulation concerning the approval of CDM projects. Before CDM projects can go through the certification process of the UNFCCC, they must receive a Letter of Approval from the Designated National Authority of the host country, e g the NDRC in China. The NDRC only issues the LoA if an Emission Reduction Purchasing Agreement (ERPA) is signed with a foreign participant prior to the request for approval. Moreover, the NDRC closely monitors the purchasing price, thus creating an actual price floor for Chinese CERs at 8 €/ tCO2eq today. The NDRC usually does not allow for a provision to lower the price in the case when the project developers partially defaults and does not deliver the expected volume of CERs in time.

This policy can put a strain on the development of the Hong Kong secondary market for two main reasons: primary buyers can not be Chinese and, project owners or developers cannot directly sell CERs on an exchange, because the buyers need to be identified, and because the ERPAs need to be entered in before the requests for LoA. Selling guaranteed CERs before having even received host country approval would require very complex and aggressive risk management. The policy of the NDRC would thus prevent many local players from accessing a Honk Kong based exchange platform, and create difficulties for HKEx to attract sellers and liquidity providers.

Even if the NDRC relaxes the constraints stated above by adapting its policies, challenges will remain for HKEx. Volume and liquidity should originate from local institutions for HKEx to have a solid foundation and be eventually economically viable. HKEx should thus look to attract local financial players.

Local financial institutions will establish the connection between the primary and secondary market, ie create the tie-up (as in Europe) between developers and financial institutions to propose guaranteed CERs. Their balance sheets will be needed to develop the secondary

CER market and manage the associated risk. Hence there is much work to be done in terms of capacity building so that local participants on the Honk Kong exchange get familiar with the carbon markets and products, the risks they are assuming, the legislative constraints and the drivers of supply and demand on emissions markets. Of course foreign financial institutions with operations in Hong-Kong would also be important liquidity providers to the market, but local banks have to become essential components of the guaranteed CERs supply side.
The post 2012 might moreover see the creation of sectoral cap-and-trade systems, in particular in China. With the experience acquired on the CER futures market, HKEx would be well positioned to become the leading trading platform for sectoral allowances as soon as they start.

In order for HKEx to develop a commercially viable trading platform, it must make sure it has well defined standard contracts, low fees compared to the European established players, and carbon transactions benefit from favorable tax treatment.

As an already active “financial hub”, Hong Kong is well placed and is the best equipped to be the leading player in the future Asian carbon markets.