JK Capital Management Ltd.

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The European Union pushes its Green Deal Industrial Plan that targets China without naming it

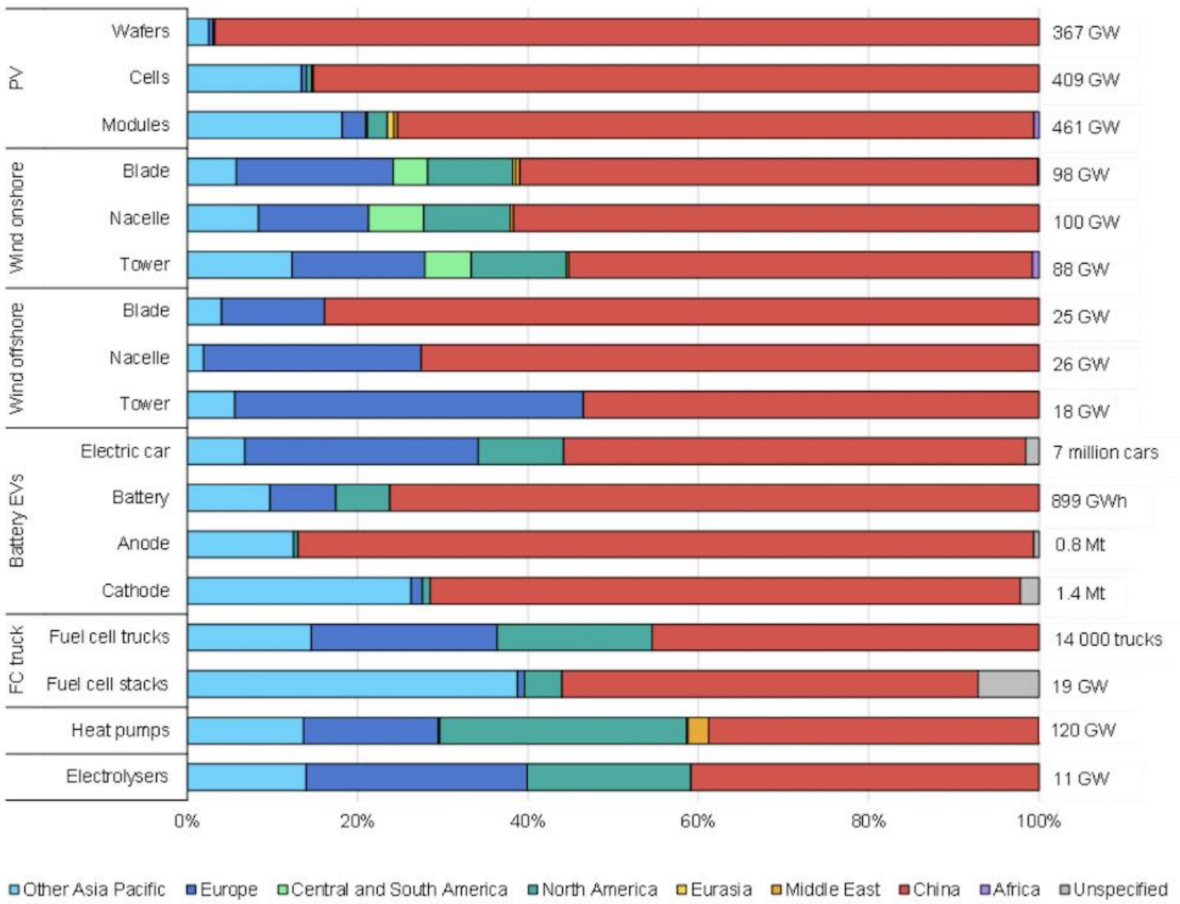
On 16th March 2023, the European Commission unveiled a two-pronged strategy to reduce its dependency on China and boost its own green industries. The **Critical Raw Materials Act** aims to diversify and enhance the resilience of the European Union's (EU) critical raw material supply chains, while the **Net-Zero Industry Act** sets out a clear European framework to reduce the EU's reliance on highly concentrated imports.

- **What is the background and purpose of these two Acts?**

The Acts are part of the EUR270bn **Green Deal Industrial Plan** announced by European Commission President Ursula von der Leyen in Davos on 1st February 2023. The proposed acts still need to be discussed and agreed by the European Parliament and by the Council of the European Union prior to being formally adopted and coming into force.

The Covid pandemic and the energy crisis triggered by Russia's invasion of Ukraine have exposed dependencies that may harm the competitiveness of certain EU industries. For instance, more than 90% of solar photovoltaic (PV) wafers and other PV technology components are imported into the EU from China. More than 25% of all electric cars and electric vehicle batteries sold in the EU are also imported from China. Globally, China accounts for 90% of all investments made in net zero technology manufacturing facilities.

Regional shares of manufacturing capacity for low-carbon technologies in 2021



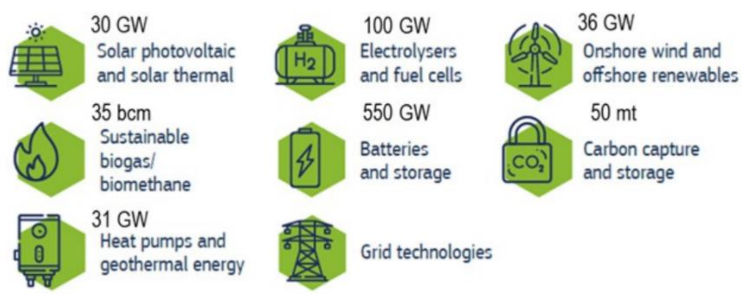
Source: International Energy Agency

Together, the two proposed Acts are Europe's response to the protectionist subsidies that are built into the Inflation Reduction Act (IRA) of the United States that is aimed at reaching energy independence for the US. The US will spend $391bn in subsidies and tax incentives to develop clean energy technologies. Since it was announced, battery and hydrogen equipment companies from several European countries including Germany, Finland and Norway have announced their intention of setting up factories in the US as the amounts of subsidies they will receive by doing so could be as much as ten times more than the subsidies they would obtain in their own countries. The Green Deal

Industrial Plan of Mrs. Von der Leyen could be seen as a defensive measure against the detrimental impact the US IRA may have on European companies' willingness to invest in Europe.

- **What are the key actions of these two Acts?**

The **Net Zero Industry Act** aims to ensure that European companies fulfill at least 40% of European demand for green products by 2030. The Act supports development in eight strategic net zero technologies, as the graph below illustrates.



Source: European Commission

The Commission also wants new factories applying for expansion in strategic net zero technologies to obtain their required permit within 12 months if they plan to add more than 1 GW of annual manufacturing capacity. Permits should be provided within nine months if the plan is for less than 1 GW.

The Act also aims to boost the supply of local net zero technologies by introducing country of origin and sustainability criteria in public procurement and auctions. Most importantly, the proposal explicitly mentions that "supply should be deemed insufficiently diversified where a single source supplies more than 65% of the total demand for a specific net-zero technology within the Union." This would mean that if a foreign country already controls more than 65% of any relevant market, its companies will have little chance of winning a public contract in the EU.

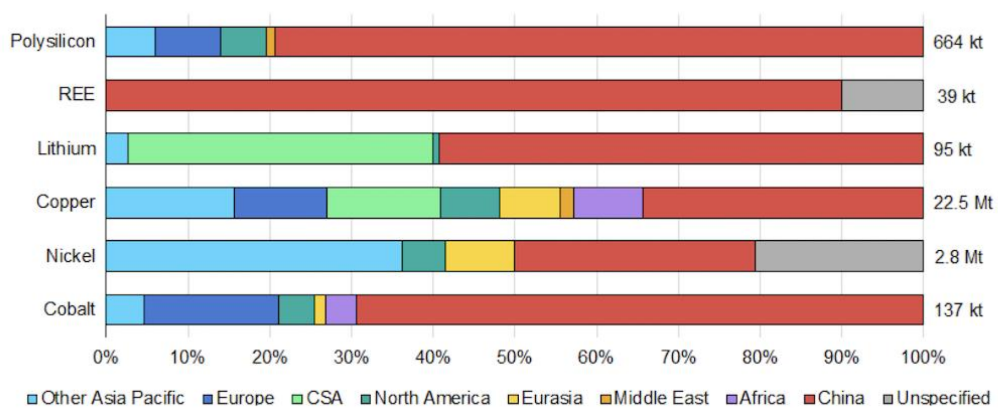
In addition, sustainability and resilience contribution which weight between 15% and 30% in the score card used to award public contracts through tenders would also effectively limit the share of Chinese products from such public procurements and auctions.

Without being named, China is clearly the bull's eye of the Act.

The **Critical Raw Materials Act** sets clear benchmarks for domestic capacities: By 2030, at least 10% of the EU's annual consumption of raw materials will have to be extracted from the EU; at least 40% of the EU's annual consumption will have to be processed in the EU; at least 15% of the EU's recycling need will have to be done in the EU; and not more than 65% of the Union's annual consumption of any strategic raw material at any relevant stage of processing could be bought from a single third country. New mining projects for critical raw materials will receive their permit within two years, and those related to processing and recycling will obtain it within 12 months.

Once again and looking at the graph below, China is the unofficial target of the Act.

Regional shares of global production of selected critical materials, 2021



Source: International Energy Agency

According to the draft, the European Commission is even willing to approve strategic projects with adverse environmental impacts if "the public interest served by the project overrides those impacts", on a case-by-case assessment. This potentially opens the door to more top-down decisions on the development of local production sites. It is also a stab in the back of environmentalists as long term economic sustainability driven by long term planning will prevail over short term environmental concerns.

- **How will EU green industries be financed and subsidised?**

EUR270bn of subsidies were earmarked in the **Green Deal Industrial Plan** announced on 1st February 2023. Some of these subsidies will come from the EU Innovation Fund that sells carbon credits through auctions before they trade on the EU Emissions Trading System (the world's largest carbon pricing system). Financing will also come from the post-epidemic recovery fund as well as from the fund that was set up to deal with the energy crisis. The balance will be funded through the European Sovereignty Fund which won't be set up by before mid-2023.

The **Green Deal Industrial Plan** is somewhat revolutionary in the sense that it will allow EU member states to subsidize some of their local industries. Until now there have always been tight restrictions on national subsidies to prevent member states from competing against each other through subsidies, and to prevent companies from benefiting from unfair advantages. The need to come up with a plan to push against the impact the US IRA may have on European companies ready to move production away from the EU has forced the European Commission to think out of the box and be more flexible about domestic subsidies. Officially, the new framework allows all member states to spend money on "measures needed for the transition towards a net zero industry" and to do so until the end of 2025.

- **What are the possible impacts on the Chinese renewables industry?**

Chinese photovoltaic companies will still have the option to invest in Europe to build factories the same way they can invest in the US. According to the US IRA, the US government will not conduct a retroactive investigation into the place of incorporation of the parent company. In the case of the European **Net Zero Industry Act**, the vagueness of the current draft's language suggests that a similar approach is likely to be adopted. In other words, it will always be possible for Chinese companies to sell their products to European clients from factories or mines located outside of China, for instance in

Southeast Asia, as long as the market share of that country's products in Europe does not exceed 65%.

China *as a country* will undoubtedly bear the brunt of the **Green Deal Industrial Plan** announced by the European Commission in the same way it is the target of the US Inflation Reduction Act. However *Chinese companies* may benefit by being the most reactive when it comes to nearshoring. Nearshoring is the act of transferring operations to countries that offer competitive business environments while benefiting from free trade agreements with the countries where the final customers are based.

Poland, Czech Republic, Romania are typical nearshoring destinations within the European Community, while Mexico is the prime nearshoring destination to address the US market as it is the main beneficiary of the 1994 North America Free Trade Agreement, known as NAFTA.

Chinese companies, including companies within the renewable sector are already moving fast into these nearshoring destinations to circumvent protectionist measures such as those described above, hence adjusting their business models that were organized until now around factories set on Chinese soil. According to CBRE, a global commercial real estate investor and manager, Chinese companies are responsible today for 50% of the nearshoring activity of Mexico, followed by companies from the United States (18%), Germany (10%) and South Korea (8%).

Going forward, we should expect the implementation of the **Green Deal Industrial Plan** and its two components, the **Critical Raw Materials Act** and the **Net Zero Industry Act** to accelerate this onshoring trend, especially for Chinese companies that are directly targeted by these new supranational regulations without being explicitly named, and that have all reasons to feel threatened.