



**Outlook of Belt and Road International Power
Cooperation in 2018**

Introduction

Since first announced in 2013, the Belt and Road (B&R) Initiative has received great support from many countries and international organizations around the world, and has gradually transformed from concept to action and from vision to reality with joint efforts from the parties involved. Undoubtedly, international power cooperation is a very important part of the B&R construction. Chinese enterprises have participated in power project construction and technical equipment exports under the B&R Initiative and yielded substantial results in exploring new models for overseas expansion via standards export, project financing, greenfield investments, stake purchase, etc.

As a growing number of international power projects are being implemented, enterprises will face increasing risks in financing, engineering construction, geographical politics, etc. Thus, power enterprises need to have a comprehensive understanding and profound insights on the development trends of international power cooperation, develop an overall planning for the “going global” strategy, promote innovation on financing models, and enhance the level and capability of internationalized operation.

Last but not least, the B&R Initiative shall not be constrained to the ~60 countries that it initially proposed. Instead, its success should be built on positive partnerships with developed countries, which will help reduce geopolitical risks and track world-leading technology trends.

Enjoy your reading!

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NASA recently released a stunning image named Earth at Night, which shows a global view of the East and West hemispheres on Earth at night and also reminds us the extreme imbalance of global power development – Europe, North America, and East Asia are densely covered with bright lights, while Africa, Latin America, and South Asia only see few lights scattered around the area.

The B&R Initiative proposes to

improve infrastructure construction and interconnectivity, of which energy infrastructure construction, in particular, is crucial for addressing the issue of power supply in underdeveloped areas. Meanwhile, China's installed power capacity is growing saturated, and Chinese enterprises with extensive experience in technology, construction and operation are accelerating their expansion in B&R countries and regions. It is true that Chinese

power enterprises have already made great achievements in the B&R construction. However, as uncertainties in international power cooperation increase due to adjustments of power planning and policies in many B&R countries, tightened carbon constraints, intensified capital competition, and unfavorable geopolitical situations, Chinese power enterprises need to be well informed and prepared for market changes.



Source: NASA https://www.nasa.gov/topics/earth/earthday/gall_earth_night.html

Coal power remains dominant with increased risks

As many B&R countries still suffer from power shortage, addressing the issue of power supply and accessibility becomes their top priority.

Considering resource endowment, demand growth, and price factor, coal power will remain the dominant source of power supply in some B&R countries for some time to come. But coal power projects are expected to face increased risks mainly for two reasons:

- potential risk of coal power projects being put on-hold.
- local policy changes.

Power demands in B&R countries are constantly growing at fast paces. Currently, the B&R Initiative has covered a population of 4.6 billion, with a power usage of 2,825 kWh per capita, much lower than the

international average of 3,295 kWh¹. In the future, power demands will maintain rapid growth in B&R countries. Power generation capacity of B&R countries in 2016 was about 5.189 trillion kWh, and is expected to grow by 70% by 2020.

Coal power will remain dominant in B&R countries. In 2015, operating capacity of coal power in B&R countries reached 1,398 million kWh, accounting for 73% of the total globally. It is predicted that by 2030, newly-installed capacity of coal power in B&R countries will reach 696 million kWh, and 900 million kWh by 2040.

International financial organizations are “conditionally” supportive to coal power project financing. For example, the Asian Infrastructure Investment Bank (AIIB) expresses that it will

consider investments into power generation projects that utilize coal in an efficient and environment-friendly manner, especially projects that retire old equipment and in regions without other alternative energy resources².

China has been working closely with B&R countries in respect of coal power projects. As of the end of 2016, China had involved in the coal power projects of 25 of the 65 B&R countries, with a total of 240 projects and total installed capacity of 25.1 billion kWh. At present, there are 52 projects pending for implementation (projects under planning and signed-off), with 7.2 billion kWh installed capacity in total, taking up 12.66% of the total coal power installed capacity pending for implementation globally; 54 projects are under construction, with 4.8 billion kWh installed capacity

Table1: Growth of power demands in B&R countries in 2016

	GDP (USD1 trillion)	Power consumption (100 million kWh)	Power consumption per capita (kWh/per capita)	CAGR of power consumption 2016-2020
B&R countries	22.6	51,890	2,825	14.5%
China	11.2	59,198	3,938	5.9%
Global	75.4	215,380	3,295	3.0%

Source: WIND, IEA, Deloitte Research

1. “Power investments lead Chinese enterprises’ ‘going global’ under the B&R Initiative”, China Electric Power News, December 26, 2017 http://www.cnenergy.org/dl/201712/t20171226_449554.html
2. AIIB plans conditionally support coal power project, China dialog, March 2017, <https://www.chinadialogue.net/article/show/single/en/9648-AIIB-plans-to-conditionally-support-coal-power>
3. “Overview of China’s participation in coal power projects under the B&R Initiative”, Global Environmental Institute, May 2017, <http://www.geichina.org>

in total, occupying 17.59% of the total under construction globally. The scale of coal power projects that involve Chinese enterprises in B&R countries shows an upward trend in general, but this momentum has slowed down slightly after the signing of the Paris Agreement in 2016.

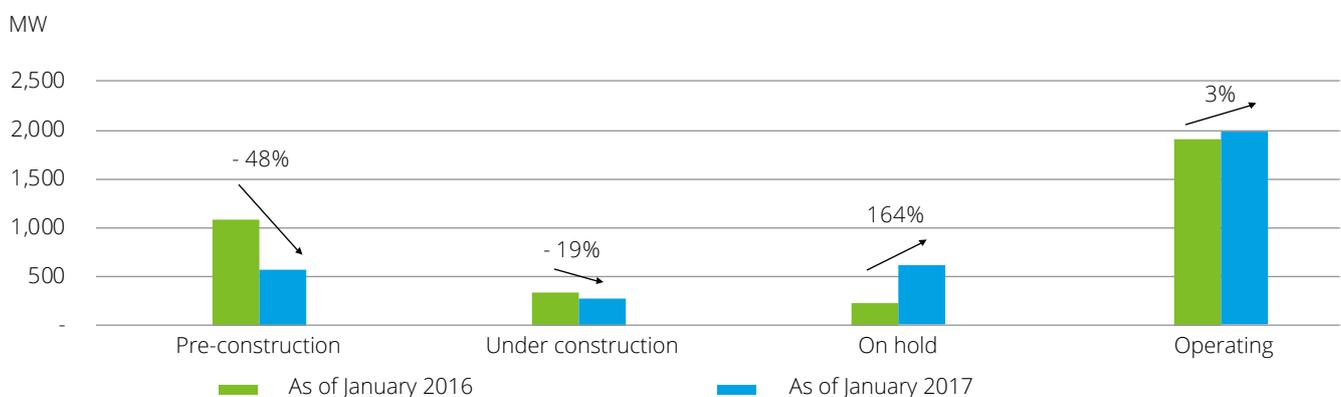
In the future, coal power projects will continue to provide most of the power for B&R countries, but they are expected to encounter higher risks. Firstly, as many coal power projects are being put on hold, projects under planning that involve Chinese enterprises may face greater risks. Compared with the same period of 2016, in January 2017, installed capacity of coal power projects

pending for implementation decreased by 48%, and installed capacity of projects under construction dropped by 19%, and the number of projects put off were 164% higher compared with that of the same period (Figure 1). As of July 2017, among all global 30 MW or above coal power projects, 600 million kWh of installed capacity was put on hold, representing 42% of all installed capacity of coal power project under planning. In East Asia, as China and Japan tightened restrictions on coal power plants, 420 million kWh of installed capacity were put on hold. In addition, main destinations of coal power investments for Chinese enterprises, such as South Asia and Southeast Asia, also saw large

number of projects being put off (Figure 2). Reasons for that include carbon constraints, financing gap, investment environment, and water resource pressure. Currently, over 40% of coal power projects China involves in are in the stages of pre-construction (including projects under planning and signed-off) and construction. Considering the growing opposition against coal power in the international community and the reality of accelerated energy structure transformation, these projects may face greater risks.

In addition to the risk of being put on hold, Chinese coal plant investments will also face risks of local policy changes. Countries including India,

Figure 1: Installed capacity of global coal power plants by stages (30MW & above coal-fired generator units, unit: MW)



Source: Boom and Bust 2017, Deloitte Research

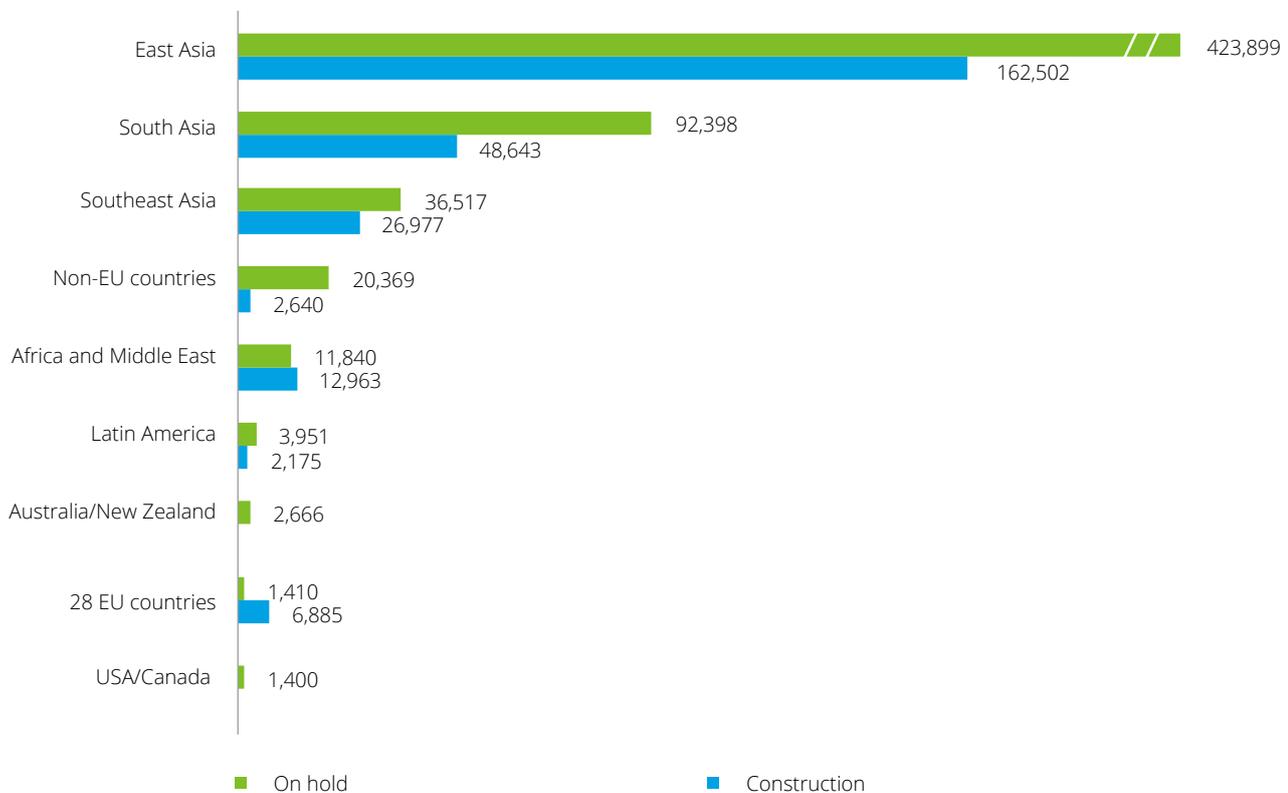
Turkey, Indonesia, and Vietnam are adjusting or reviewing their coal plant planning; Middle East countries, with economy impacted by falling oil prices, and South Asia countries, due to political factors, are tightening tax inspections on Chinese coal power enterprises.

Given that China's international power cooperation with B&R countries

will remain to be dominated by coal power projects, Chinese enterprises must shape a comprehensive understanding of the above risks. In the future, the focus of China's thermal power exports should shift to improving energy efficiency ratio and reducing pollutant emissions of coal power plants. Moreover, power enterprises also need to pay close attention to changes in local industry,

investment, and taxation regulations. In case of unexpected tax inspections, enterprises should promptly seek help from professional legal and tax consultants to avoid unnecessary tax losses.

Figure 2: Coal power plant projects under construction and on hold by region (As of July 2017, 30MW & above coal-fired generator units, unit: MW)



Source: Boom and Bust 2017, Deloitte Research

“New reality” of renewable energy

Renewable energy and the advance of energy storage technology are rapidly reducing the costs of power generation using renewable energy and even enabling it to compete with traditional fossil energy. As the cost of renewable energy decreases, many countries are actively planning for renewable energy projects while

adjusting and reducing subsidies. In the future, the success of renewable energy projects will depend more on investors’ understanding of local markets, rather than support of feed-in tariffs. Investors will need to conduct more thorough and detailed assessments in local markets on new or substitution

demands for renewable energy, the degree of financing difficulty, power sales agreements, and local political, economic, and business environments.

The B&R countries have huge potentials in growth of power capacity of renewable energy. As estimated

Table 2: Favorable renewable energy policies and adjustments in some countries

Country	Feed-in tariff policy	Competitive bidding for renewable energy projects	Tax credits for investment or production	Sales tax, energy tax, VAT and other tax reliefs	Public investment, loan, royalty, capital subsidy or other privileges
Poland	Y	Y		Y	Y
Czech	R			Y	Y
Germany	R	Y	Y	Y	R
UK	R			Y	R
France	R	Y	Y	Y	R
Indonesia	R	Y	Y	Y	R
Philippines	R	Y	Y	Y	Y
Vietnam	Y	Y	Y	Y	Y
India	R	Y	Y		Y
Pakistan	R			Y	Y
Saudi Arabia		Y			
UAE		Y		Y	Y
Egypt	R	Y		Y	Y
US	Y		R	Y	R

Note: Y: related favorable policies in place, R: related favorable policies are adjusted

Source: REN21, Deloitte Research

from IEA data, new power capacity of renewable energy in B&R countries will reach approximately 1.94 billion kW by 2030 and 2.6 billion kW by 2040. Based on the target date for carbon emission reduction goal set by the Paris Agreement, by 2030, new power capacity of renewable energy in B&R countries will generate up to 3.5 trillion kWh of electricity. Of all the B&R countries, Europe, India, and Africa have the greatest potential in renewable power generation, which is in line with their local resource endowments and development demands, followed by Southeast Asia, Japan, and the Middle East ⁴.

Over the past year or two, policymakers have been reducing feed-in tariffs and a growing number of European and Asian countries have replaced feed-in tariff with competitive bidding for large power generation projects. In Europe, the European Commission has approved the changes to power price bidding by large projects in several EU member countries. Countries including Germany, France, Czech, Slovenia, Poland, UK, and Ukraine have also adjusted their policies regarding feed-in tariffs. In Asia, China and Japan have reduced feed-in tariffs for solar power; Pakistan has lowered its on-grid solar power price by 36%; and the

Philippines has also proposed a third round reduction of feed-in tariff. Only Indonesia goes the opposite way to increase its on-grid tariff by 70% for solar power and set a fixed on-grid price for geothermal energy. In Africa, Kenya announces to change all feed-in tariffs to competitive bidding; Egypt releases new on-grid tariff policies, requiring that 30% of capital for solar power projects and 40% for wind power projects must be funded by domestic parties.

In addition to rules for feed-in tariffs, many countries have also adjusted financial and tax policies on renewable power generation projects and other supporting policies. Iran has required a 35% of localization rate for solar power and wind power plants; Turkey has specified that wind power plants may have a 50% increase in price if all the wind power generators are produced domestically, while the price of power generated by imported solar panels will be cut in half.

China is working increasingly closer with B&R countries in renewable energy sector. In 2016, China invested a total of USD7,655 million in power industry projects in B&R countries, more than twice of that in 2015. Of which, hydropower and clean energy investments accounted for

48%, thermal power 21%, power transmission and transformation 16%, mineral resources 9%, and others about 6%⁵.

In addition to renewable energy greenfield projects, renewable energy has always been an important target asset for overseas M&As by Chinese power enterprises. In 2017, 50% of overseas M&A transactions made by Chinese power enterprises took renewable energy assets and enterprises as targets. Chinese power enterprises seek overseas M&As mainly for two purposes: first is to acquire advanced experience, technologies, and standards from overseas enterprises; second is to identify quality projects and make financial investments.

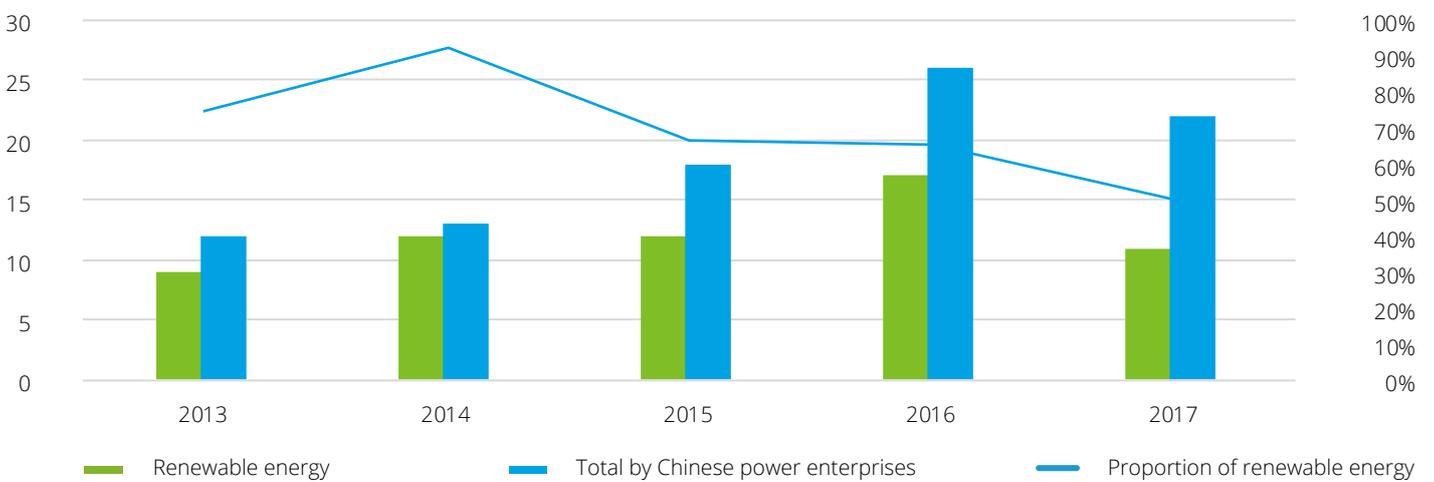
As B&R countries have great potentials for future renewable energy development, investment in both greenfield projects and overseas M&As by Chinese enterprises shows an upward trend. However, power enterprises need to pay more attention to fundamental market factors, closely follow the trends of cutting-edging technologies in overseas markets, and be prepared for increasingly frequent policy adjustments and subsidy reductions.

4. “Cooperation potential and implementation path of B&R power cooperation”, Caixin.com, August 4, 2017 <http://m.opinion.caixin.com/m/2017-08-04/101126236.html>

5. “Broad prospect for the cooperation between power and high energy-consuming industries along B&R”, China Industry News, October 20, 2017 <http://fec.mofcom.gov.cn/article/tjgcnhz/xgzxhlj/201710/20171002657363.shtml>

Figure 3: Renewable energy as the main target asset for overseas M&As by Chinese power enterprises

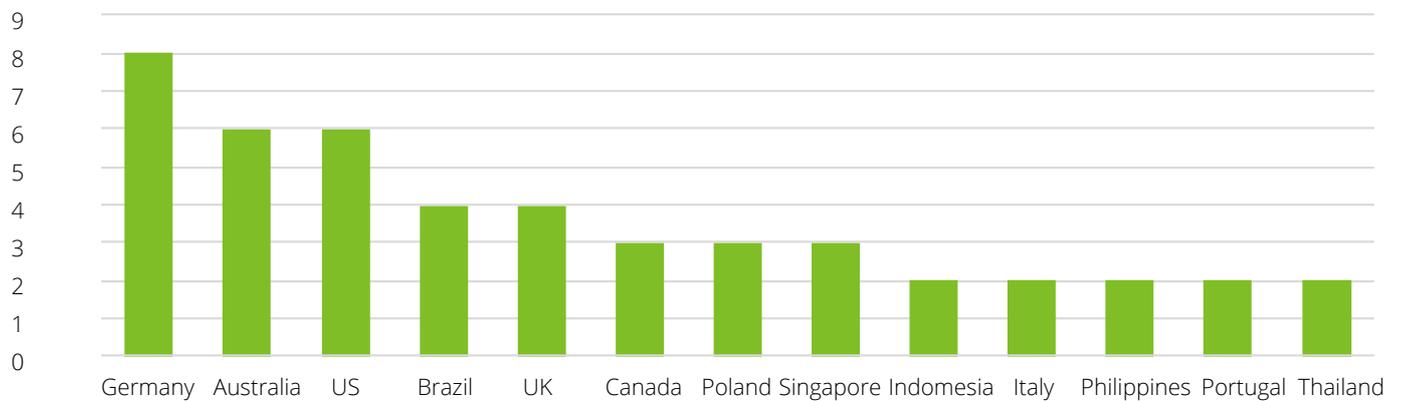
No. of overseas M&A transactions by Chinese power enterprises



Source: mergermarket, Deloitte Research

Figure 4: China's overseas renewable energy M&As mainly target at developed countries

Main target countries of China's overseas renewable energy M&As during 2013-2017 (No. of transactions)



Source: mergermarket, Deloitte Research

We will see more investment and M&A projects in the future, and much of the growth in overseas M&A projects will come from expansion of existing power plants in target countries and withdrawal of existing investors.

Sam Li
Deloitte China Tax Partner



A long way to go for grid interconnectivity

Infrastructure interconnectivity is a priority in the B&R construction, and power grid interconnectivity is an important part of it. But it is undoubtedly an arduous task considering the sensitivity of power grids and the complexity of state grids in B&R countries.

Given their backward power grid construction and high transmission

loss rates, upgrading power grid becomes an exceptionally urgent task for many Asian countries. For instance, in Pakistan, losses resulted from transmission and electric larceny account for nearly 25% of the country's total power supply, and, during peak hours in summer, outage hours can last as long as 12 hours in urban areas and 16 hours in rural areas⁶.

The construction of cross-border power grid interconnectivity of B&R countries has also been launched in many regions. In Central and Eastern Europe, countries have built power grid interconnection within the region and with Russia as they are small in size and close to each other with strong links in power grids. In Central Asia, a long-chain power grid structure from the north to the



6. "Overview of Infrastructure in Pakistan", China International Contractors Association (CHINCA), April 22, 2016 <http://obor.chinca.org/fxyj/55433.jhtml?country=499>

south mirroring the load centers has developed as a looped network covering Kazakhstan, Uzbekistan, Kyrgyzstan, and Tajikistan. In South Asia, there have been connected transmission lines between Nepal and India and between Bhutan and India, through which Nepal and Bhutan import some power from India during dry seasons and export to India during wet seasons. In Southeast Asia, power grid interconnectivity has been built between most of the Greater Mekong sub-regions, including interconnections between Laos, Thailand and Vietnam; Cambodia and Laos, Thailand, Vietnam; Malaysia and Thailand, Singapore; etc. In Middle East, with great support from the Gulf Cooperation Council, countries including Saudi Arabia, Kuwait, Qatar, Bahrain, UAE and Oman have achieved interconnection of power grids. According to data from IEA, B&R countries transact about

130 billion kWh of electricity every year, approximately 3.1% of total consumption⁷.

International power cooperation can firstly focus on cross-border power grid connection and transmission projects with neighboring countries to realize cross-border power consumption and supply-demand balance on a small scale. In underdeveloped B&R regions, Chinese power enterprises may promote power grid interconnectivity projects and expand EPC and BOT markets with an aim to develop holistic solutions integrating “Chinese technologies + Chinese standards + Chinese equipment + Chinese construction”, and, at the same time, follow opportunities to acquire quality overseas power assets. Power assets in epitaxial B&R regions including Europe and South America are also attractive to Chinese

power enterprises as regulated and transparent regulatory frameworks in these countries may warrant stable profits. These countries are selling minority stakes in their power grids for privatization, which brings acquisition opportunities for Chinese enterprises.

7. “Cross-border power grid interconnectivity promotes B&R facilities connectivity”, Gao Guowei, China Electric Power News, June 13, 2017 https://feed.baidu.com/feed/data/wise/landingpage?s_type=news&dsp=wise&nid=3838166396441913914&n_type=&p_from=4

Develop overall “going global” plans

Now power enterprises are not only interested in power infrastructure projects, but also attach greater importance on long-term development strategies in B&R markets and how to satisfy demands of local stakeholders. To tap the potentials of B&R markets, power enterprises need to develop overall plans and innovate new patterns with focuses on packaged integration, localization and interconnectivity of standards.

“If you want to go fast, go alone; if you want to go far, go together.” In certain underdeveloped regions, we have seen some successful cases of packaged business undertaking by groups of enterprises. In these cases, the general contractor takes full account of the overall infrastructure construction planning, including electricity, roads, water utilities, building management, etc. and cooperates with experienced companies in different projects to build a mutually beneficial community of interests. Such comprehensive projects will bring much higher profits than single ones and greater benefits for local people. From the perspective of vertical integration, the power industry needs to explore a new path of “EPC + investment + operation + brand” packaged exporting, and, at the same time, keep a close eye on the latest technology trends in developed countries to achieve fast expansion through M&As.

Localization can be improved from three aspects. First, shift to early market development, where enterprises not only implement power projects to satisfy power demands in local markets, but also provide clients with insightful visions to help them effectively plan for power source construction and power distribution based on the whole country's energy demands. Second, talent localization. As many Chinese enterprises requires a great number of expatriates, from technical staff to production personnel, in their overseas projects, which results in high operation costs, it would be very difficult to reduce such costs without talent localization. Third, actively respond to local interest demands, promptly release project details to enhance transparency, and keep local people informed of the improvements in their lives as a result of Chinese investments to build a win-win-for-all public image for the B&R Initiative.

Standards are the technical language and criterion for interconnectivity. Building cross-border industry chains requires not only the export of Chinese equipment and Chinese capitals, but also international recognition of Chinese standards, Chinese technologies, and Chinese services. As it would be quite difficult to apply Chinese standards in the international market, Chinese power enterprises need to develop “going global” plans for Chinese

standards. In areas with immature or no power standards, Chinese power enterprises may develop power standards together with the B&R countries concerned and take the lead in the development of standards regarding their advantaged technologies; in areas with stringent standards, enterprises firstly need to master the established standards and then consider how to bridge advanced Chinese standards with existed overseas standards. Though standards, technologies, and services are soft strengths, they are always much more important than hard strengths.

“One of our clients was a general contractor in a Nigerian infrastructure construction project for a whole area. The breakthrough for the project was to improve the livelihood of local people for the government, rather than making profits from single project. Such EPC projects often generate good profits.”

Yu Yun
Deloitte China Energy & Resources
Industry Risk Advisory Leader

Innovative financing models

B&R countries are generally weak in economic strengths, and, at the same time, power infrastructure construction requires large amount of funds. To ensure sustainability of power projects under the B&R Initiative, China needs to explore new financing models, with project financing as the main model, and establish multiple financing channels.

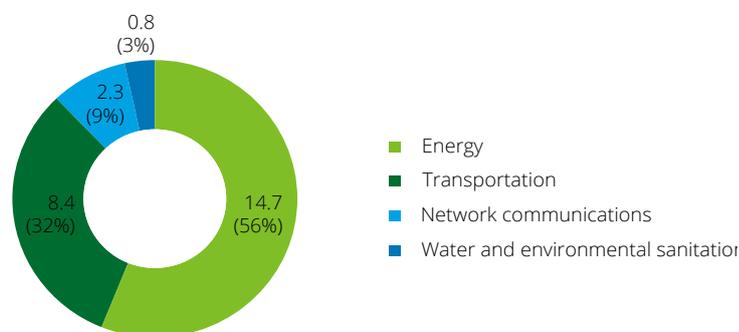
As estimated by the Asian Development Bank in 2017, from 2016 to 2030, developing countries in Asia would require investments of USD26 trillion in total for infrastructure construction, of which, USD14.7 trillion (56%) are energy investment demands (Figure 5). Based on this estimation, Asian countries would require an average investment of USD1.7 trillion for infrastructure construction each year, much higher than the current level of near USD900 billion⁸.

As overseas power projects require huge sum of funds and has long pay-back cycles, overseas power project owners often consider equipment quality, price, and the ability of contractor to bring successful financing as well as the amount and costs of financing. Given a huge gap of funds supply and demand, financing is becoming a key factor to owners when making tendering and bidding decisions.

As calculated based on Thomson Reuters' global loans data, energy and power sector loans in B&R countries totaled USD183.2 billion in 2017, among which, 112 loans were project financing loans, with a total of USD54.7 billion, the top of all loan categories. Compared with enterprise guaranteed credit financing, trade financing, and traditional corporate financing, project financing helps raise funds without owner guarantee or with limited guarantee through structured design, which can effectively release owners' balance sheet pressures, greatly enhance capital liquidity, and improve investment efficiency. Owners often tend to choose project financing as it has longer loan terms that could cover the whole construction period of power projects, lower financial

requirements on the owner side, and less pressures on re-financing. However, there are several major challenges for project financing. First, as project financing has high requirements on the project's business contract and structure, enterprises may miss the opportunity of project financing if they adopt the same "simple practices" on business arrangements of similar projects as in domestic market; second, as foreign banks, international multilateral financial organizations or banks operating in project location are just starting to provide project financing services, Chinese enterprises need to take this opportunity and build up different capabilities (e.g. overseas assets, business negotiation talents, communication skills with local governments, identification of interna-

Figure 5: Demands of investment in infrastructure construction in Asian developing countries from 2016 to 2030 (unit: USD1 trillion, %)



Source: Asian Development Bank ("ADB"), Deloitte Research

8. "Asia Infrastructure Needs Exceed \$1.7 Trillion Per Year, Double Previous Estimates", AIB, February 28, 2017 <https://www.adb.org/news/asia-infrastructure-needs-exceed-17-trillion-year-double-previous-estimates>

tional law and local legal risks, market analysis and study of government planning, etc.); third, as local project sponsors generally have relatively low credit ratings and are unable to provide satisfactory credit guarantee to banks, Chinese owners and the project itself may face greater responsibilities and risks when collaborating with local partners. Moreover, lenders also have stringent requirements on risk control, and Chinese enterprises are becoming increasingly prudent in providing financial guarantee for project loans due to relatively high debt/asset ratios.

In addition to project financing, each party shall actively explore innovative financing methods, such as project bonds, bonds+ consortium loans, equity investment financing and other combinations of multiple financing channels.

Project bonds provide institutional investors an opportunity to invest in infrastructure projects through tradable securities and offer risk-adjusted returns. There are two major challenges for project bonds: first, bond issuers generally have low credit ratings or even have no credit ratings; second, due to long construction cycles and low acceptance among investors, it is very difficult for green field projects to adopt this method. Alternatively, enterprises may consider the method of "corporate bonds (during construction) + project financing (after completion)" to reduce the risks brought by long construction cycles. For certain projects that need to raise funds for acquisition or start construction within a short period of time, enterprises may also adopt the method with bridge loan and project financing combined. Under the circumstance of fierce com-

petition for funds, capabilities of fast fundraising, low debt/asset ratio, and low-cost financing are crucial for shaping key competitiveness. As financing for overseas power projects involves multiple parties and complicated structures, engagement of financial consultants with suitable experience in financing, industry and the target investment country is often required to assist enterprises in respect of business architecture design, financial model development, financing plan design, financial model building, and financing negotiations till the completion of project financing.

Table 3: Energy and power sector loans in B&R countries in 2017

Use of funds	Loan amount (\$100 million)	Proportion	No. of loan transactions	Proportion
Project financing	547	30%	112	39%
General corporate purposes	429	23%	36	13%
Capital expenditure	352	19%	69	24%
Re-financing	339	18%	39	14%
Working capital	62	3%	19	7%
M&A financing	25	1%	4	1%
Others	79	4%	8	3%
Total	1,832	100%	287	100%

Source: Thomson Reuters, Deloitte Research

“It’s a long way to go for project financing to be widely accepted by Chinese banks, but they are increasingly willing and taking actions to participate in project financing. Certain Chinese banks are even acquiring foreign banks to enhance their experience in project financing.”

Patrick Fung
Deloitte China Energy & Resources
Industry Financial Advisory Leader

PPP project valuation

As the number of projects under the B&R initiative increase, project structural design becomes more and more important. Some projects are directly funded by governments, some apply traditional credit guarantee and some adopt the trendy model of “EPC+F” (engineering design, procurement, construction plus financing). Apart from these models, public-private partnership (PPP) model is also gaining momentum.

Considering the reality of backward infrastructure construction in Africa and Southern Asia and the impact of low international oil price on the Middle East, many countries in these regions are seeking equity investments on condition of ownership or control rights over the infrastructure. As a result, PPP model becomes an option that ensures both infrastructure construction and ownership.

As the Chinese government promotes outward investments and encourages acquisition of equities in overseas projects and assets, more and more Chinese enterprises begin to engage in overseas infrastructure investments, seeking other roles apart from being contractors. Indeed, collaboration with countries who value China’s professional experiences may bring win-win results. However, as PPP projects require strong capabilities in controlling cash flows and risks, enterprises should conduct a thorough financial analysis before participating in PPP projects in order to avoid being stuck in reverse due to long investment cycles.

Financial models can be used to analyze project payback period, return of investment and cash flows, as well as enterprise sustainability in three aspects: first, assess whether the enterprise can sustain under cash flow pressures (including the stability and controllability of cash flows, and local tax policies etc.) through accurate analysis of cash flows of the future project; second, as enterprises often work with local governments on more than a single project, whether the current project can bring replenishment of subsequent projects and project clustering; and third, how such projects contribute to improvements in the industry chain and integrated operation of the enterprise.

Conclusion

Looking ahead in 2018, coal power will remain a main source of power supply in B&R countries, but risk expectations may increase due to carbon constraints and a large number of projects being put on hold. The success of renewable energy projects depends more on investors' understanding of local markets, rather than feed-in tariffs. Given the fact that power grid interconnectivity still has a long way to go, enterprises should start with neighborhood projects that are easier with fewer conflicts. Chinese power enterprises are not only looking at profitability of a single project and a single enterprise, but also beginning to expand with broader perspectives and explore innovative models. Their foresights and actions give us grounds for optimism.



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