Financing Green

The China Report

IN THIS ISSUE - AUGUST 2017

China's Carbon Market: On Track but Smaller Scale

China will launch a nationwide carbon market before the end of 2017, but it will not be the grand version originally envisioned. Challenges, such as collecting accurate data on carbon emissions in key industrial sectors, determining the ongoing role of the regional pilot markets, the lack of the sophisticated trading tools, and the absence of an existing regulatory structure, are all creating complications as the government takes this important step. Once created, however, the world will be watching closely as this carbon exchange will be -- at birth -- the largest in the world. Its success, or lack-there-of, will have a significant impact on the future of carbon trading policies around the world.

Read More On Pages 2-4

保尔森基金会
PAULSON INSTITUTE

保尔森基金会
PAULSON INSTITUTE

China's Carbon Market: On Track but Smaller Scale (cont.)

In 2015, President Xi Jinping announced his intention to create a nationwide carbon market based on the experiences of the successful pilot projects in seven regional markets around China, which have been used as test cases for the past four years. Now, with their future uncertain, the leading markets, such as Beijing, Shanghai, Hubei and Guangdong are competing to be the headquarters for the new national center. Beijing and Shanghai are the most likely candidates, given their central locations and sophisticated financial systems. It is not clear at this stage what will become of the other regional systems. According to our interviews with leading experts, the nationwide market could be launched by October.

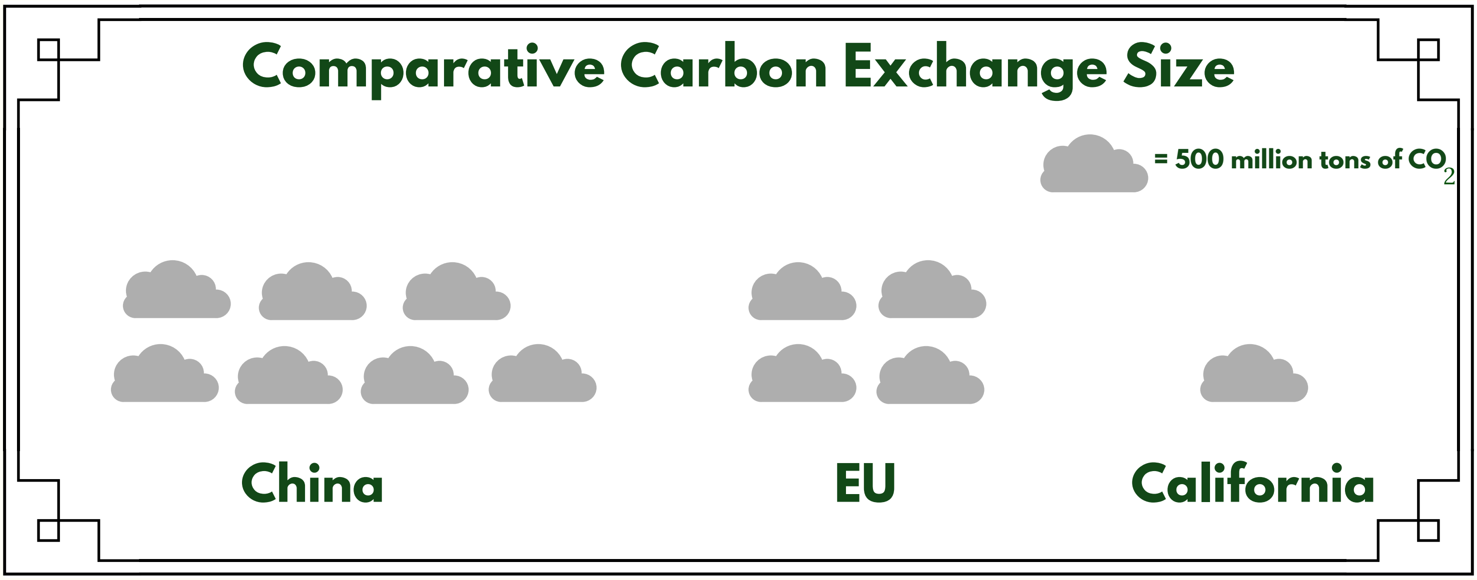
To ensure a smooth and manageable launch, the National Development and Reform Commission (NDRC), which is overseeing the development of the carbon markets, limited this initial stage to three sectors – power, aluminum and cement – rather than the eight originally expected. Reliable data could only be retrieved for these three sectors, despite the experiences of the regional markets, and the one-year nationwide reporting and verification of baseline tracking of inventory emissions data in the eight key sectors that were originally planned to be included.

This one-year examination unveiled numerous problems in data collection, data systems, and in the allocation of allowances. At least for the three sectors selected, they share the advantage of simplified industrial processes, a solid and more developed data system, and an easier approach for carbon allowance allocation based on the measured carbon intensity per unit. Over time, we expect that the remaining five major sectors – oil petroleum, chemical, iron & steel, paper mill and aviation– will be added to the nationwide exchange, although maintaining a consistent and fair allowance allocation will be a challenge across such diverse industries on a nationwide basis.

China's Carbon Market: On Track but Smaller Scale (cont.)

Also, initially, only companies with an annual comprehensive energy consumption over 10,000 tons of standard coal equivalent (tce) or 26,000 CO_2 will be allowed to trade on the nationwide market, which brings the market scale for commencement to over 5 billion tons of CO_2. For comparison, the EU system is currently trading around 2 billion tons.

Another challenge is that the regulatory framework for the launch of the national market is yet to be approved. While it is not uncommon in China for “experiments” to be tried and tested before the legislation is passed, the regional pilot projects have been tested for four years, and there are still no detailed implementation regulations. The NDRC submitted a draft of the Legislative Regulations of China Emission Trading System to the State Council in 2016, which has yet to be approved.



The detailed regulations are important because, beyond establishing the legal framework, this legislation indicates the key Ministries involved in regulating the markets: an essential clarification as the NDRC is not a financial regulator yet has oversight for the spot trading market, while the China Securities Regulatory Commission (CSRC) is expected to have oversight and responsibility for creating the futures trading market.

As seen recently in the insurance sector, clever traders are often able to arbitrage regulatory loopholes between different regulations, and it is essential that enforcement between the two ministries be seamless.

In addition, for the traders, the allocation system has yet to be clarified. Besides this aforementioned legal challenge, the long-term policy expectations, and policy coordination and recalibration, there are technical rules on issues. These rules include cap defining, allocation approaches, monitoring, reporting, and verification (MRV), accreditation of third parties and offsetting that need to be further studied for improvement.

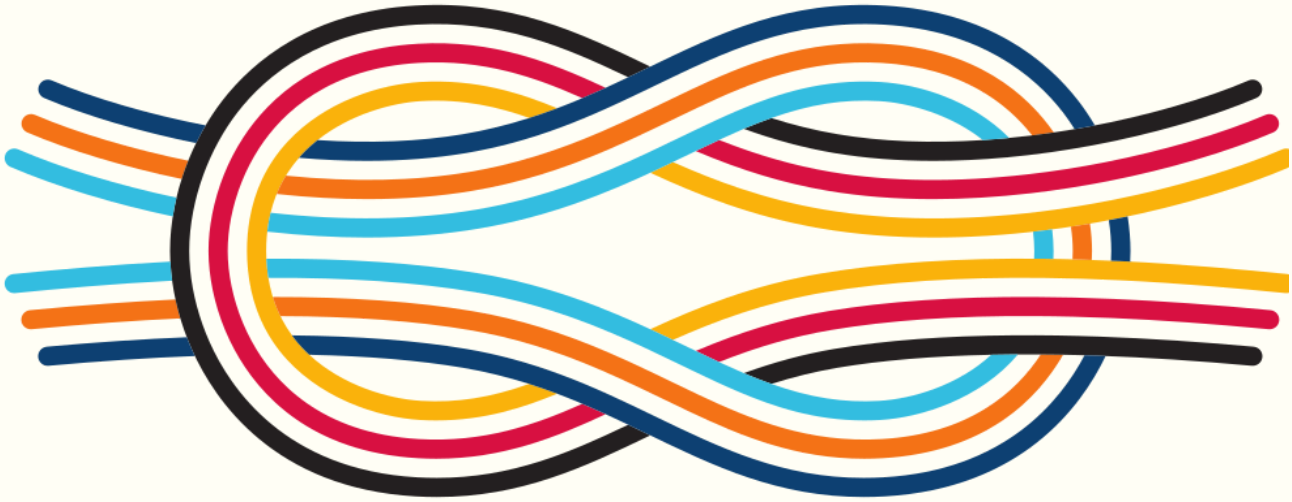
China's Carbon Market: On Track but Smaller Scale (cont.)

Determining a price for carbon, which will impact market liquidity, is another aspect yet to be finalized. Officials at the NDRC estimate that the initial price of carbon on the exchange will be 30-40 Yuan/ton. If this is the case, the NDRC estimates that the initial market will result in between 1.2 and 8 billion Yuan (US $170 million to $1.16 billion) of over-the-counter trading annually. As more sectors and therefore more firms, are added, clearly the amount of trading will increase and it will also have an impact on the pricing of carbon.

Another impact on the amount of trading, besides the price, is that only the spot market will initially be opened while the CSRC tests the concept of a carbon futures market on a small scale in a pilot project, most likely at the Guangdong Carbon Exchange. It may be a few years before nationwide futures trading is available, which will make the overall market much more appealing.

Lastly, the decision has not been finalized on how the nationwide and the regional markets will work together. Initially, it appears that they will function in parallel. Large scale, nationwide companies will trade on the national market, while smaller sized regional companies will trade on their local exchange. But over time, the competitive regional markets could distract from their parent, and draw funding away. It could result in a bifurcated and confusing system of some firms trading nationwide, some locally, and some may be subjected to another means of carbon pricing in the future, such as a tax. This complicated system would create significant inefficiencies and would be exceedingly complicated to enforce.

China has significant challenges ahead to reduce carbon emissions, but, as told to us by a Chinese official, it is China and they will launch a successful nationwide carbon market in 2017. It will take several years to grow to be a competitive, widely inclusive, and global marketplace, but when it does, it will play a significant role in helping reduce emissions not only in China, but potentially in other markets as well.



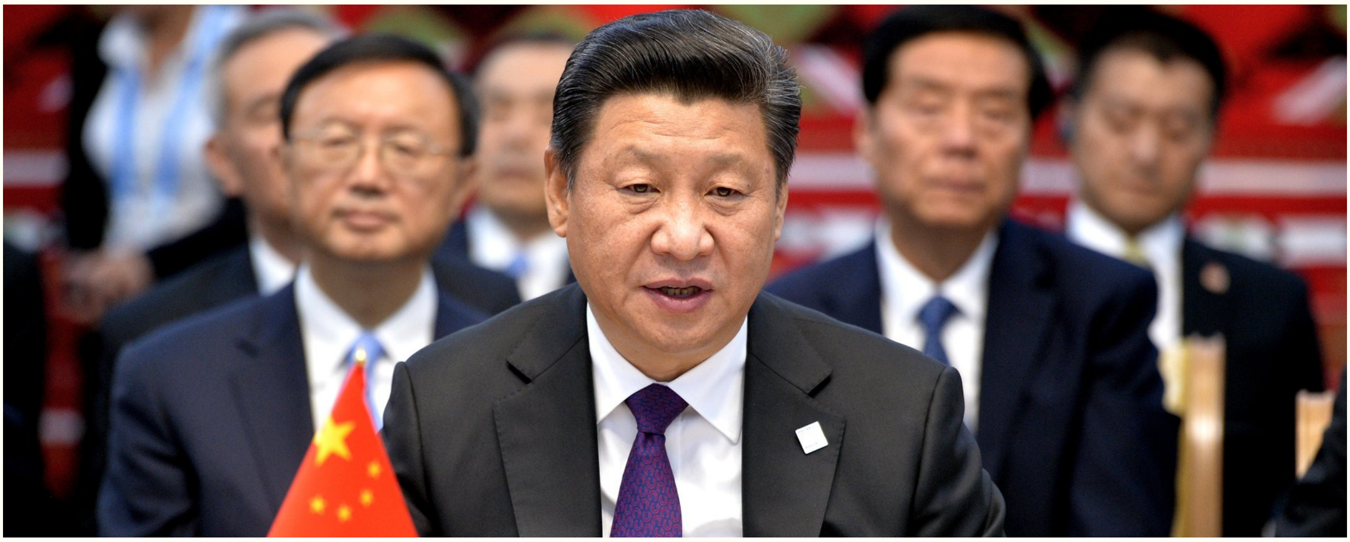
Green Finance a No-Show at the G20

To much fanfare at last year's annual gathering of the G20 heads of state, under China's presidency, the Green Finance Study Group released recommendations as well as agreement by the leaders on ways that innovative financing structures can drive green development.

This past July, just one year later, the new U.S. Administration blocked any mention of green finance. The Communiqué released in Hamburg does not have a single mention of the topic, despite the continuing work of the green finance study group. This group was established to explore policies that governments can introduce to tap into capital markets to attract private capital for green development. However, in his speech at the summit this year, President Xi Jinping mentioned the importance of green finance initiatives in saying the G20 should strengthen, "green finance to make the financial sector truly drive the development of the real economy."

Commitments that many governments made as part of the Paris Agreement cannot be funded through public financing solely; they will require significant amounts of private capital. In the case of China, for example, it has estimated that they will need up to $600 billion annually for five years to bring about the necessary changes, yet the government can only finance approximately 15 percent of these costs. The rest will need to come from the private sector as well as innovative financing vehicles.

The Paulson Institute has been supporting China's efforts – and those of the Green Finance Study Group – for the past two years in exploring how best the private sector can help reduce carbon emissions. Ultimately, it requires good government policy combined with private sector opportunity to ensure long-term success. Yet with the Trump Administration's concerns about the Paris Agreement and overly aggressive rules on the private sector in the name of climate change, it is not clear what role the U.S. capital markets will continue to play as others – especially China and Europe – continue to charge full speed ahead.



One Belt One Road: A Path to Green Finance

In May, China held the biannual Belt and Road Forum for International Cooperation where 1,500 delegates from more than 130 nations—including 29 foreign heads of state and more than 200 ministers—met in Beijing. Launched in 2013, the One Belt One Road (OBOR) initiative aims to expand links between Asia, the Middle East, Africa, and Europe by recreating the ancient Silk Road trade routes by land (the Belt) and sea (the Road).

The stated intent of the OBOR initiative is to "promote economic cooperation and connectivity" across these regions through a massive infrastructure development project. This is President's Xi's signature foreign policy effort, with the goal of reorienting the global economic order by building what has been dubbed the "project of the century."

At the forum, President Xi made a point of raising the importance of green development as part of his opening remarks: "We should pursue the new vision of green development and a way of life and work that is green, low-carbon, circular and sustainable. Efforts should be made to strengthen cooperation in ecological and environmental protection and build a sound ecosystem so as to realize the goals set by the 2030 Agenda for Sustainable Development."

China has put on notice the participants in the OBOR initiative that standards for "green" will be part of its requirements for infrastructure loans and projects. If truly the case – and enforced – this effort could have significant impacts on global policies around these issues. The world will be watching in hopes that China's actions will live up to its rhetoric

Financing Green

Upcoming Events

Upcoming Event: International Forum on Green Finance

The International Green Finance Forum will take place on September 5th, 2017 in Beijing. This forum aims to disseminate the findings of G20 Green Finance Study Group presented to the G20 Hamburg Summit, to further promote the mainstreaming of green finance, to discuss specific green finance tools and products such as environmental risk analysis and green bonds, to explore ways to enhance the green preference of investors investing in the Belt & Road region, and to explore new areas of green finance development such as Green FinTech. The Paulson Institute is co-supporter of the event with the Green Finance Committee and others.

Vice Chairman Deborah Lehr, quoted on Carbon Trading Market

Deborah Lehr, Vice Chairman at the Paulson Institute, was quoted in a New York Times **article** on the Carbon Trading Market in China: “One of the problems they [China] have had is getting realistic numbers. To move emissions trading, you need to have realistic numbers on how to start to price these emissions.”

China Adviser for PI, Gracie Sun to speak on Green Finance

Gracie Sun, China Adviser for the Paulson Institute, will be speaking to Chinese provincial leaders in a training seminar on August 18th about the importance of Green Finance. At this seminar, hosted by the PBOC Research Institute, she will speak on the Green Fund, in support of the Building Energy Saving initiative.