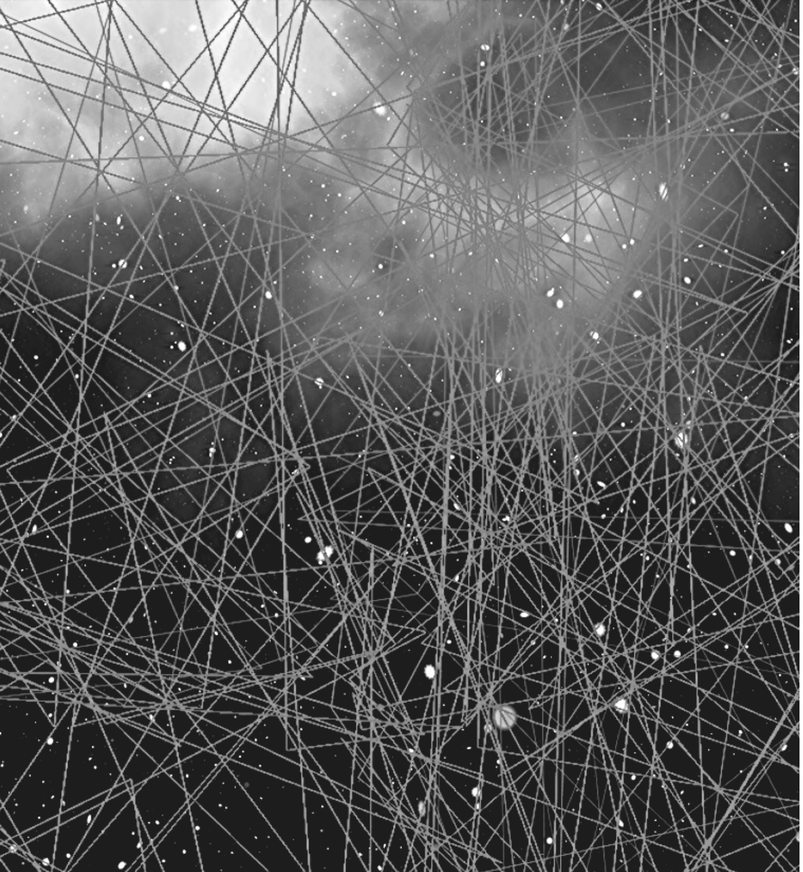
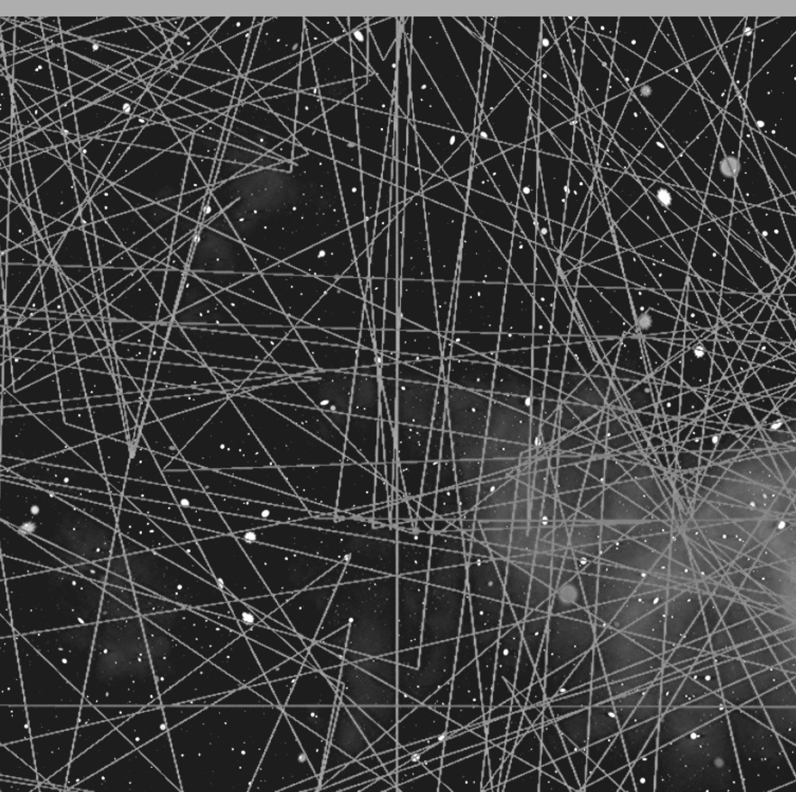



STRENGTHENING POLICY COORDINATION TO FULLY OPERATIONALIZE CHINA'S NATIONAL CARBON MARKET

Leveraging Finance for Green Policy Briefs

Li Xiaozhen

December 2019




ABOUT THE AUTHOR

Li Xiaozhen (Kate) is Associate Director of Green Finance Center at the Paulson Institute.

Prior to joining the Paulson Institute, Ms. Li worked at China's largest state-owned enterprise in energy conservation and environmental protection–China Energy Conservation and Environmental Protection Corporation (CECEP) for over 10 years. She took the lead in providing technical assistance and consultancy in the field of green finance and low carbon development in China. Her clients mainly included the Chinese government agencies, the World Bank, the Asian Development Bank, the EU delegation, KfW, and the British embassy.

EXECUTIVE SUMMARY

China's long journey to develop a carbon trading system has been several years in the making, and its success will be important not only to China, but also to the rest of the world. While China has a robust agenda for carbon trading, its current policy coordination systems are not sufficient to support it. And strengthening these mechanisms should be considered a top priority as China aims to begin national carbon market trading in 2020.

In 2018, carbon market responsibilities were transferred to the Ministry of Ecology and Environment (MEE). This move legitimized the MEE's mandate over the carbon market. It also led to some policy alignment as seen in the MEE's involvement with the leading group on climate change, its release of the Draft for Comment on Interim Regulations for Management of Carbon Emissions Trading, and its initial action with the China Securities Regulatory Commission (CSRC) to advance carbon futures.

Despite this progress, there are challenges that remain—the limited or nonexistent involvement of the People's Bank of China (PBOC), CSRC and the China Banking and Insurance Regulatory Commission (CBIRC), the lack of regulatory policies for carbon accounting and carbon asset management, and weak capacity building for carbon trading and carbon asset management.

The ability to fully operationalize the national carbon market will be driven in part by the coherence of underlying coordination mechanisms established by the MEE that tackle the gaps and challenges. And in this context, three recommendations are offered in an effort to streamline and advance policy coordination.

- **Facilitate a cross-ministry carbon market regulatory framework with clear responsibilities and coordinating mechanisms**
- **Scale up carbon finance with a clear road map and a variety of trading instruments**
- **Improve capacity building and knowledge sharing of financial markets**

These recommendations aim to cultivate key characteristics of good policy coordination that would support an effective national carbon trading system in China, which in turn could be significant for further uptake of carbon pricing schemes – and the future of carbon trading and climate change policies around the world.

INTRODUCTION

The image of modern skyscrapers shrouded by an unnatural haze is emblematic of both China's rapid economic growth and its environmental degradation. After 40 years of reform and opening up, China is facing the challenge of transforming and upgrading its economic development model, shifting from high-speed growth to high-quality development. The Chinese government has issued a great variety of market-based instruments to develop synergies for promoting green and sustainable economic development, and the national carbon market is one of the market-based instruments we focus on here.

In December 2017, China announced the launch of the national carbon market, based on the experiences gathered from its regional pilot markets since 2013. The national carbon market will be operational by 2020 with the power sector and will then gradually expand to include other sectors. Tapped to be the world's largest carbon trading market, the success of China's national carbon market will not only be important to China, but also to the rest of the world.

China has an ambitious agenda for carbon trading, but the policy coordination system currently in place does not support it. The strategy for the national carbon market should work across multiple sectors and ministries. In 2018, shifting the mandate for national carbon market responsibilities from the National Development and Reform Commission (NDRC) to the Ministry of Ecology and Environment (MEE) was a step in the right direction.

China has an ambitious agenda for carbon trading, but the policy coordination system currently in place does not support it. The strategy for the national carbon market should work across multiple sectors and ministries.

However, a top agenda priority that has yet to be achieved is strengthening the policy coordination among MEE and other relevant ministries, especially the engagement of financial regulators, to establish effective cross-ministry dialogue and operating mechanisms. Such policy coordination is key to the development of a sustainable nationwide carbon market in China.

CURRENT STATE OF AFFAIRS

Operation of the national carbon market has been delayed due to the shift of national carbon market responsibilities from the NDRC to the MEE in 2018, but there has been some progress toward better alignment of policy nonetheless.

First, the Chinese government is continuing to build a more robust coordination framework for addressing climate change. In 2007, China established a leading group under the State Council to strengthen its enforcement of climate imperatives. The Premier led the leading group of senior leaders from State Council departments, and coordination of these issues was delegated to the NDRC.

In August 2018, this structure was reorganized. In a break with tradition, the MEE was elevated to co-lead the coordination work with the NDRC. It is worth noting that the governor of the People's Bank of China (PBOC) became a member of the leading group at this time as well, which hints at an increasing realization that a holistic approach to climate change action is needed to effectuate policy coordination among multiple ministries.

Second, the MEE was given the legal mandate to take the lead and push forward regulatory frameworks for policy coordination. In April 2019, the MEE released a Draft for Comment on Interim Regulations for Management of Carbon Emissions Trading (Draft for Interim Regulations). It stipulates that MEE is responsible for the supervision and management of activities related to the national carbon market, and the Chinese government plans to establish a mechanism that will be responsible for investigating and coordinating key issues.

Third, the China Securities Regulatory Commission (CSRC) is making a concerted effort to work with MEE to develop a carbon futures pilot. China began to establish its green finance system in 2016 with the intent to develop carbon financing derivatives and explore the establishment of a carbon futures trading market, which would build upon the national carbon market. China's State Council unveiled in the Outline of Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area in February 2019 that the carbon futures pilot would be established in Guangzhou. To implement this policy, the plans require collaboration between the CSRC and the MEE to test the concept of a China carbon futures market on a small scale, in a pilot project.

THE GAPS

Despite the attention at the highest levels and advances on a few fronts, there remain gaps in alignment of policies that prevent the market from being fully operational and efficient.

There are debates among stakeholders already on how to improve policy coordination. Take for example the question of how the national carbon market can collaborate with a number of other market-based instruments and initiatives that are already underway. These include energy-cap and energy-saving trading for improving energy efficiency overseen by the NDRC, and issuing green electricity certificates for developing renewable energies, supervised by the National Energy Administration (NEA). Further, as the market moves to real market trading, there remains a demand for policy coordination with regard to market operation and financial regulation.

Identifying these gaps and challenges is the starting point for the process of enhancing policy coordination and developing appropriate mechanisms for China's national carbon market.

The largest coordination gap exists between the environmental ministry and the financial regulators. In shifting the regulatory mandate of the carbon market from the NDRC to the MEE, the coordination gaps between the two became more apparent. Carbon market involvement of China's financial regulators, such as PBOC, CSRC and the China Banking and Insurance Regulatory Commission (CBIRC) have been limited or nonexistent to date. A glaring case in point is that until this year, the CSRC, the futures market regulator, has not been involved the State Council's leading group on climate change enforcement or in China's carbon market construction.

Second, there is a lack of regulatory policies for carbon accounting and carbon asset management. The PBOC and six other ministries had included the development and integration of the national emissions trading system (ETS) and carbon financial products into China's green financial system in 2016, but the policies for carbon trading and financial products have not been connected with the bulk of China's other green finance policies. For instance, there are few regulations for carbon accounting, financial audits and taxation for those companies who want to improve their carbon asset management and information disclosure in China's national carbon market. Issuing these policies and regulations is an urgent and practical step that the MEE should take in coordination with the regulators responsible for financial management, taxation and audit.

Weak capacity building for carbon trading and asset management is another challenge to be addressed. After seven years of pilot market experiences, the local governments and enterprises in the carbon trading pilots—Beijing, Shenzhen, Shanghai, Hubei, Guangzhou, Chongqing and Tianjin—have developed many capacity building programs with knowledge for understanding and participating in pilot markets. But these programs have largely focused on the policy overview and technical issues, and therefore there is a lack of relevant training on carbon trading and carbon asset management. And in non-pilot regions, government officers and enterprises need to learn not only professional knowledge, but also practical skills for participating in a national carbon trading market.

> **The largest coordination gap exists between the environmental ministry and the financial regulators.**

The national carbon market is slated to begin trading in 2020, which is quickly approaching. Some key questions remain unanswered:

- To what extent will the financial regulators be involved in China's national carbon market?
- To what extent will the carbon market be better linked to the financial market to leverage private funds for low carbon investment?
- To what extent will the local governments and companies be ready to participate in the national carbon market?

RECOMMENDATIONS

China's long journey to develop a carbon trading system has been several years in the making, and its success will not only be important to China, but also to the rest of the world. The ability to develop a fully operational and effective national carbon market will in part be driven by the coherence of underlying coordination mechanisms established by the MEE. And in this context, the below recommendations are offered in an effort to streamline and advance policy coordination.

1. Facilitate a cross-ministry carbon market regulatory framework with clear responsibilities and coordinating mechanisms

A national carbon market is a complicated and considerable undertaking. When it is the world's largest carbon market, its development and operation should be methodical and systematic, and facilitated at the highest levels.

The MEE has been given the mandate to lead the advancement of China's national carbon market. It has also been granted leadership of the leading group addressing climate change, which includes NDRC and PBOC members. As such, it is important to develop structures to facilitate a cross-ministry regulatory framework, policy coordination and working mechanisms.

The release of a draft for comment on rules for management and supervision of the national carbon market in early April this year clearly indicates the government's aim to establish a coordination mechanism for carbon emissions trading. While this was a positive signal for policy coordination, it still lacked implementation details.

In this vein, the MEE should work with the PBOC, CSRC and CBIRC to set up a joint supervision system for the national carbon market.

- The MEE would take responsibility for technical regulations on caps setting, allowance allocation and compliance, Chinese Certified Emissions Reductions (CCER), registry, and monitoring, reporting and verification (MRV) systems.
- The financial regulators would take the lead in applying rules governing financial markets to improve market oversight. For example, the CSRC would oversee carbon futures trading, and CBIRC would manage carbon financing and insurance.

These suggestions would ensure a more harmonized approach to national carbon market operation that is inclusive of all the relevant stakeholders.

The ability to develop a fully operational and effective national carbon market will in part be driven by the coherence of underlying coordination mechanisms established by the MEE.

2. Scale up carbon finance with a clear road map and a variety of trading instruments

The MEE has proposed a timeline for developing the national carbon market—fully operational by 2020, and carbon derivatives trading explored in 2021-2026. As a component of the greater Chinese green finance system, the national carbon market should be linked to encourage policy options and market instruments like derivatives that will stimulate capital inflow to low carbon development.

Coupling the carbon market and financial market at the national level is likely to lead to scale and diversification in the market.

- The MEE should coordinate with relevant financial ministries to jointly develop a road map for carbon finance that would provide a framework to manage key green finance targets and approaches aligned with the national carbon market agenda. The roadmap would serve as guidance for China's development of carbon market policies and set a long-term policy signal to the market.
- The CSRC could take the lead to conduct a specific evaluation of the financial risks related to the national carbon market and develop custom financial regulations for the national carbon market accordingly. This would help address any potential negative underlying risks in the market and minimize those effects.
- The MEE could work with the CSRC to explore the development of a carbon futures pilot in a specific industry or region. Akin to the carbon market pilots, the lessons and experiences learned would support and inform the launch of a carbon futures market at the national level in line with the agenda of the national carbon market.

3. Improve capacity building and knowledge sharing of financial markets

Capacity building is vital to China's national carbon market development. Various capacity building programs have been launched since 2012, but there remains a significant demand as the national carbon market moves toward its fully operational mode in 2020. One area where more capacity building would be worthwhile is in increasing understanding of the financial markets among relevant players.

The financial market is key to developing a robust market for carbon trading. China carbon market development should be considered in a broader context, such as state-owned enterprises (SOEs) reform, economic restructuring, capital market development, and financial regulation development. Some capacity building proposals could include the following.

- Bringing financial experts to work with carbon financial leaders to develop a knowledge sharing platform or innovative products that would help advise the development of spot, futures, and other related financing vehicles and structures.
- Facilitating programs that include the finance- and tax-related government agencies, because carbon trading is closely linked. Collaboration among these agencies will improve their knowledge of the carbon markets and garner their support for a national carbon market at central and local levels.
- Encouraging more practical training opportunities for participating enterprises in the carbon market. The enterprises will need assistance in developing a carbon asset management system, enhancing their risk management capacity for carbon trading, and improving their carbon-related information reporting and disclosure.

These three recommendations will not be easy to achieve. It will require a mix of strong, high-level political will and able leadership. Yet if accomplished, the Chinese carbon market and larger green finance system would both greatly benefit.

CONCLUSION

The MEE released a draft for comment on interim regulations for the management of carbon emissions trading about a year and a half after the announcement of China's national carbon market, but this was a significant moment. The draft for comment offered a clear indication of determination to fully operationalize China's carbon market, but it outlined the improvements needed in policy coordination for it to come to fruition.

China has faced many challenges in the process of building a national carbon market. There are issues regarding the lack of a legal regulatory framework, infrastructure system for registration and trading systems, and MRV management. The demand for additional capacity building is also a roadblock to address.

One way for the MEE to tackle these issues is to dedicate resources towards strengthening the policy coordinating mechanisms for operation and regulation of the national carbon market. An effective system will help to solve some of the many gaps that exist in the process of establishing and operating the national carbon market. Facilitating a cross-ministry carbon market regulatory framework, scaling up carbon finance with a clear road map and a variety of trading instruments, and improving capacity building and knowledge sharing of financial markets are key characteristics of good policy coordination that would support an effective carbon trading system.

Given China's role in the global economy and its further opening up to financial services in the short-term, the practices of China's national carbon market—slated to be the world's largest carbon trading market—will have significant impact on the further uptake of carbon pricing schemes and the future of carbon trading and climate change policies around the world.