China Carbon Forum | 中国碳论坛

An independent platform to foster trust and cooperation among China's stakeholders for climate action

China's national emission trading scheme and the European perspective – what to expect from 2017?

Executive Summary

This event was part of the European Union (EU) – China ETS Project, which was initiated in 2014 to support the design and implementation of greenhouse gas emissions trading in China. ICF International is leading the International Technical Assistance Team (ITAT) that is assisting China, and China Carbon Forum (CCF) co-hosted the event with ICF International and the Beijing Energy Network.

The panel included distinguished experts on emissions trading schemes from Europe and China. The audience gained insights on the latest progress of EU-China collaboration on ETS, including design and capacity building work. The panel discussion covered the key issues around ETS design both in the EU and China, including allocation mechanisms, benchmark-setting, price management and MRV. The Q&A session allowed participants to engage with panelists on some of the biggest challenges facing China's national ETS, including the prospect of over-allocation, and treatment of trade-exposed industry. After the discussion, the guests enjoyed the follow-up networking event.

Record of Discussion

The following is an edited synthesis of discussion that took place at the event among panelists (around 40 minutes) and open Q&A with participants (1 hour). As per convention, individual's comments are not attributed.

This discussion takes place in the context of the recent signing of the Paris Agreement by 175 countries. How to implement the commitments in the Paris Agreement is a question being confronted by all of the Parties to the agreement. **Both the EU and China have decided that emissions trading**

schemes (ETS) will play an important role in achieving their targets. The EU and China have been cooperating on climate change for several years now, and this event provides a good opportunity to shine more light on that cooperation.

The panel noted that the EU has been closely following the robust process that China is going through to set up a national ETS by 2017, which will provide a "strong signal to the world". The successful rollout of China's ETS **will be strategically important as an indication of preference for ETS as a policy instrument to achieve policy objectives**. When the Chinese ETS starts it will cover twice the volume of emissions covered by the EU ETS, and the scope of global GHG emissions covered by ETS's globally will almost double. China's ETS will also help China to reduce emissions in an effective and efficient manner, opening the door for even more ambitious objectives, as has repeatedly occurred in Europe. China's ETS will be the world's largest, and will represent a significant example for other countries looking at ETS, especially if China gets it right. It will also be an important step towards a level playing field for industry globally, making the path to low carbon economy smoother.

In the Joint Statement of the EU-China summit in June 2015, China and the EU agreed to "further enhance existing bilateral cooperation on carbon markets, building upon and expanding on the on-going EU-China emission trading capacity building project and work together in the years ahead on the issues related to carbon emissions trading". The two sides are engaging in bilateral cooperation through the ongoing EU-China ETS project. Projects focus on training and capacity building, in line with what China needs for the time being, **but will increasingly also involve policy dialogue, as appropriate between the two largest carbon markets in the world**. This also involves discussion on how cooperation may continue after the conclusion of the current EU-China ETS project at the end of this year.

Furthermore, an important experience from Europe is that the EU ETS must be subject to constant improvements, in order to benefit from the findings emerging from the past, and to take into account actual developments. China's gradual approach is wise and useful in this context. The EU had its own learning curve, dealing with problems relating to the robustness of data during the first phase, then harmonization during the 2nd and the 3rd trading periods, overcoming the fragmented approach applied before. This included harmonization on the cap, common rules for auctioning, benchmarks, and a centralised system during the 3rd phase. It is important to get the system in place, and then improve it through practice. **Once policy is in place, with a political commitment, there is political will to calibrate and adjust as necessary**. Clear targets and rules give predictability to business.

During the EU ETS 4th trading period from 2021 to 2030: the European Council of October 2014 has decided to cut European GHG emissions by 40 % compared to 1990 by 2030. In order to achieve this target, the EU ETS has to reduce its covered emissions by 43% compared to 2005 and to pave the way towards a low carbon economy. Therefore, in the 4th trading period the EU must increase its linear reduction factor from 1.74 to 2.2%. A high share of auctioning will be maintained (57% of all allowances will be distributed through auctioning). The number of sectors on carbon leakage list will be reduced. Benchmarks will be updated to reinforce incentives for innovation. Free allocation will be maintained, but more targeted. EU leaders have decided that this approach will continue until EU competitors face similar carbon prices. **These measures will help to incentivise new technologies and assist companies to make the necessary transition**. Low carbon funding mechanisms include: The Innovation Fund, which will be bigger in size (more allowances monetized) and bigger in scope (including industry); the Modernisation Fund representing 2% of ETS allowances, which aims to modernise the energy sector and energy efficiency of the 10 lower income Member States, and help them with the transition. Free allocation to the power sector for these member states will continue, but the quantity limited.

The EU China ETS project has been running for over two and a half years. This week involved important training sessions in Beijing, and the event is an opportunity to share its progress through the networks of Beijing Energy Network (BEN) and China Carbon Forum (CCF). Every week progress is evident, and this is measured through the quality of presentations, whether from industry, local and national government. The complexity of the topics able to be addressed has also progressed. In the first year, training covered the basic building blocks of ETS, **whereas now there is much mutual learning around how to manage and regulate the market**. For example, participants are engaged with the process of managing CCERs, which has resulted in realisation of the need to reform CCER accreditation in order not to undermine the purpose of the ETS.

The project has covered the importance of road-mapping and action plans in the rollout of the national ETS. It took time to recognise the relevance of this, but **China is now committed to taking on board lessons learned for implementation of the national ETS**. Discussion of MRV has built on the capacity building projects funded by Norway and Australia. Communication and synergy between capacity building efforts is important, and the outputs of all projects are shared. Monitoring plans are becoming important. Where they were formerly voluntary, they are now making their way in to law. The monitoring system for the national ETS will be web-based, a major advantage for a country as large as China.

China is aware of problems with allocation faced by the EU. The NDRC is currently gathering data on emissions before deciding on allocation for the 1st phase of the national ETS. Some pilots were more thorough than others in this regard. **Current pilot market prices reflect to some extent the impact of different decisions on allocation**. Over time, China will build a better data system as the basis for the national ETS to be effective, if not in the 1st phase, then post 2020.

Most pilots lack a legal framework for ETS, making enforcement and compliance difficult. For the national ETS, legislation is identified as a priority in the State Council's work plan for 2016. However it was mentioned that it is placed behind about 80 other areas of priority, suggesting there may be some barriers to be overcome before legislation is passed. The panel noted that progress of legislation always depends on the level of political will from the top leadership. There is still at least one year prior to the beginning of the national ETS, however, so there should be time to complete the legislation in time for a launch in mid-2017 or possibly later. **It is possible that by the time of the launch the legislation will not be ready, but if not then it will be shortly after the launch**. Project participants have also been involved in consultations with government on this issue.

The EU's impact on the Chinese ETS has been enormous. **This relationship helps to answer the question as to why China decided to pursue ETS instead of a carbon tax**. Going back to 2005, CDM was introduced to China, allowing China to understand and participate in the carbon market. The EU was the driving force for CDM. The NDRC, responsible for CDM, is also responsible for the ETS. For the pilots, MRV guidelines and the framework of regulation reflects EU influence. The national MRV guidelines, pilot monitoring plans and accreditation systems are all very similar to the EU. **The lessons have also been learned, most importantly on allocation**. Chinese pilot allocation is very unique and different from the EU. Policymakers learned about the risk that uncertainty over economic growth can create for over-allocation, and this is reflected in pilot allocation. While the problem has not been totally mitigated, policymakers have worked hard to learn the lessons. National allocation will similarly be bottom-up and based on benchmarks, although these are different from the EU. While EU benchmarks only use historical production data, China's refer to current year output, meaning that each year there will be an initial allocation followed by adjustment at the end of the year. In this way pilots have tried to avoid the problems faced by the EU.

Progress for the national ETS is going well. A landmark notice was recently issued by the NDRC (Notice 57), which provided the framework of the Chinese ETS, key steps and priorities for national and local DRCs, including the collection of data, and a timeline for testing and improving allocation plans. Provinces are currently working on their action plans, and most have finished designing their 3rd party

verification systems. Progress varies, however, depending on whether their team is strong or weak. Capacity building is still needed. On top of this project, the national government has established several ETS training centres to focus on priority areas to help prepare enterprises. **The question is not how the system is designed, but rather how people are "doing their job"**, considering the lack of experience in non-pilot regions.

The start of the national ETS will be important for engaging enterprises. Prior to the launch, many companies may be reluctant to engage. **The launch, therefore, will essentially be political indicating to stakeholders that they now have an incentive to engage**, and the risk that the launch date won't be met is extremely low. 2017-2019 will be a trial and improvement phase, meaning that it will not be a robust system in 2017. However, given the progress to date, China is on a good track, including the work of DRCs, verifiers, companies (developing strategies), and exchanges (accommodating new products). The work on carbon finance products is already happening but its progress depends heavily on government policy. Stakeholders are currently waiting for direction in this regard. They are also waiting for a robust carbon price. Both of these things will follow once a functioning carbon market exists.

We don't yet know how stringent the overall cap will be, although at the beginning it probably will not be very strict. Following the pilots' lead, there will be a process of learning and improving. The guidelines published so far are brief and not detailed. While the NDRC is consulting experts and stakeholders, many big companies that will be covered move slowly, and that may hold up the process. In the Beijing pilot for example, some companies only engaged one week prior to the first compliance deadline, faced a high price, and were punished by the government. The following year they realised that engagement was important. Most large companies not already covered, are not currently engaged very much at all. Some ask why the government doesn't consult and engage with these companies. Actually the intention is there, but the response sometimes is slow. Once the formal allocation plan or test allocation is announced, and companies realise that they have a shortage, they will become active and engaged.

The NDRC has said there will be a small proportion of allowance auctioning, but the percentage is not yet clear. The platform to be used for this auctioning is also unclear. NDRC is currently working hard to get a list of the companies, and data for 2013 and 2014 to support allocation. This is the current priority, along with engaging local government, as they don't currently have sufficient capacity. This process has also drawn on the EU-China ETS project.

There has not yet been consideration of a price floor for China's national scheme. A market stability reserve was introduced a year ago in the EU. This recognised that policy makers should not choose the exact price, and could not agree. The reserve therefore allows re-calibrating. Even after 10 years, adjustments are still needed. The Beijing pilot has a theoretical upper and lower price, but this has not been put in to practise. Discussion for the national ETS has focussed on a flexibility mechanism to start from 2017. **The exact arrangement will depend on the overall design of the ETS, and may include price triggers for adding or removing volume**. This has been explored under the support of the World Bank's PMR program. Current pilot prices will also have an impact on the beginning of the national ETS.

The government is creating a comprehensive set of policies to lead an industrial transition. Recently, the NDRC issued a notice on expanding the program of low-carbon pilot cities, and this year there will be about 100. The notice included a requirement for cities to have a clear target on peaking emissions. Although there is not yet a strong carbon price, many industries have sensed the policy direction and are starting to factor it in to their operations. This includes increased access to finance for low-carbon energy options from banks which are following policy closely. **Therefore, we should not just look at the carbon market alone to provide incentives, but rather the whole policy framework which is driving structural change**. In the early stage of the ETS it is not necessary to have a high carbon price, but rather to set the cap so that it creates the incentive for companies to reduce their emissions.

While the EU ETS has always delivered on its objectives, in terms of emission targets, **it has perhaps not yet been successful in shifting major investment towards low-carbon sources**. This is partially because the price signal was not strong enough to push in that direction. The EU reform process intends to address this. The EU ETS is also not the only policy addressing climate change, i.e. renewable targes, energy efficiency targets, regulation of vehicle emissions. The EU would like the carbon price to play a more prominent role in shifting investment.

The process of learning during the first 3 year phase of the ETS will be tremendously important. The three compliance cycles will allow regulators to learn from practice, and we should expect changes to be made during the first phase. They will then be well-placed to ensure that post-2020 it is increasingly effective. The economic conditions now are much different from those when ETS was first considered, meaning that ETS is an important tool, but also may be adjusted to reflect the 'new normal'. By 2020 there should be well qualified people and good enough data to make the right decisions. One difference between the EU and China is that in the EU there may be thorough

discussion and consideration of a particular issue. In China, issues tend to be dealt with one by one, as they arise. The NDRC has limited staff, similar to challenges in other policy areas. For this reason, patience is required in regard to progress on the national ETS.