Principles for Responsible Investment

# CONSULTATION RESPONSE

## CHINA INTERIM REGULATIONS ON THE CARBON EMISSION TRADING SYSTEM

**April 30, 2021**

## ABOUT THE PRI

The United Nations-backed Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 3800 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $103 trillion in assets under management.

Responsible investment explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets.

The PRI is working to help investors protect portfolios from risks and to expose them to opportunities in the shift to a low-carbon global economy. The Emission Trading System (ETS) could be an important market-based instrument to help China to hit CO2 emission peaking by 2030 and deliver carbon neutrality by 2060. The national ETS initially covers the power sector, which accounts for over 40% of China's energy-related CO2 emissions[1] and will be expanded to other energy-intensive sectors. The development of the ETS and its impact on the low-carbon transition of energy-intensive industries in China are significant to global investors. Investors continue to expect policy reform towards a low-carbon global economy: delaying policy action now will likely lead to further, more disruptive, intervention later.

The PRI welcomes the opportunity to contribute comments and suggestions to China's Interim Regulations on the Carbon Emission Trading System.

## ABOUT THIS CONSULTATION

China is going through a critical period of transition to a resilient, sustainable and low-carbon economy aligned with the Paris Agreement and the Sustainable Development Goals. The proposed Interim Regulation on the Emission Trading System (ETS Regulation) has been developed by the Ministry of Ecology and Environment (MEE). It aims to provide a legal framework that sets the high-level goals, principles and direction for the development of the national ETS in China which is crucial to achieving the goal of carbon neutrality, green transition and ecological civilization.

## THE PRI'S RESPONSE TO THE CONSULTATION

The PRI welcomes the consolidation of existing ETS regulations into a new State Council regulation. Setting up a comprehensive regulatory framework for the national ETS is an important step for China in building a market-based mechanism to guide China's economy onto a pathway of low-carbon transition aligned with the Paris agreement. The PRI welcomes inclusion in the proposed ETS regulation the goal of emission peaking and carbon neutrality. In particular, the PRI welcomes:

- The establishment of a coordination mechanism among different regulators (Article 4)
- The introduction of a cap on carbon emission allowances (Article 8)
- The establishment of the National Carbon Emission Trading Fund (Article 21)
- The mandatory information disclosure requirements for key emitters and regulators (Article 19)

[1] https://www.iea.org/reports/the-role-of-chinas-ets-in-power-sector-decarbonisation

- The gradual transition from free allocation of emission allowances towards market-based allocation (Article 8)

The PRI's key recommendation for the MEE is that the proposed ETS Regulation is an opportunity to cement and strengthen Chinese leadership on climate change. In line with developments in over 70 countries worldwide[2], **the PRI recommends enhancing the effectiveness and coverage of the national ETS by:**

- **Setting out a timetable for transitioning to a fixed cap emission trading scheme.** As China aims to peak its emissions before 2030 and to reach carbon neutrality before 2060, limiting its total emissions in addition to reducing emissions intensity will be essential. In this regard, transitioning from an intensity-based cap to an absolute cap on emissions in the national ETS would reduce the risk of encouraging the construction of high carbon assets and ensure coherence with China's plan for carbon neutrality. An intensity-based cap is likely to result in a low price of carbon and will be increasingly complex and challenging to design as the national ETS expands its coverage beyond the power sector.
- **Introducing the auctioning of allowances.** Sole reliance on the free allocation of permits is likely to lead to the oversupply of allowances, windfall profits for efficient coal power generators and thereby limited impact on Chinese policy goals to reduce emissions. By gradually phasing in the auctioning of allowances would help accelerate the energy transition whilst allowing market participants time to adapt.
- **Announcing a target 2030 floor price of $60 per tonne of CO2.** The introduction of the auctioning of the allowances will establish a floor carbon price for the Chinese ETS market. This could be complemented with a ceiling price which together with the minimum (floor) price rises over time. This price collar would drive fuel switching in the power sector, create greater predictability for companies and investors in direction of Chinese energy policy. In line with research from the World Bank[3] and PRI's Inevitable Policy Response programme[4], a floor price of $60 per tonne by 2030 would be consistent with Paris Agreement goals.
- **Coordinating power market reform to enhance the effectiveness of ETS**. Reforms to China's electricity markets which favours the least cost power dispatch will be vital for an effective Chinese ETS. Building on the success of regional pilots, accelerating the role of the market mechanism in how power is dispatched, and the deregulation of China's electricity markets is recommended.

Globally, investors are increasingly tightening their climate strategies, including the commitment to net zero emissions by 2050. Some of the world's largest asset owners have joined this target through the UN-convened Asset Owner Net Zero Alliance. The investor-led Climate Action 100+ has now close to 575 investors engaging with high-emitting companies to reduce GHG emissions.

The PRI has experience of public policy on climate disclosures and responsible investment and real economy policies across multiple markets and stands ready to further support the work of the Chinese

[2] http://sdg.iisd.org/news/77-countries-100-cities-commit-to-net-zero-carbon-emissions-by-2050-at-climate-summit/

[3] Report of high-level commission on carbon prices (2017) Report of the High-Level Commission on Carbon Prices — Carbon Pricing Leadership Coalition

[4] The Inevitable Policy Response 2021: policy forecasts https://www.unpri.org/inevitable-policy-response/the-inevitable-policy-response-2021-policy-forecasts/7344.article

regulators on promoting a carbon neutrality strategy aligned with the Paris Agreement. Any questions or comments can be sent to policy@unpri.org.

## DETAILED RECOMMENDATIONS

### Article 1 [Purposes]

**The PRI recommends that the purpose of the legislation should include " addressing climate change".**

The article mentioned regulating carbon emission, achieving carbon peaking and carbon neutrality targets, and delivering green transition as purposes of this regulation. All of them are means to address climate change, not the end.

### Article 5 [Coverage of the ETS]

**The PRI recommends that the competent department of the State Council for ecology and environment shall publish a list of key industries and specify a timetable for the inclusion of key industries in the carbon emissions trading system.**

By giving the market a clear and predictable policy signal, this regulation will help market players in key sectors to get ready for carbon accounting and carbon reporting according to the official timetable. It also supports investors to obtain corporate carbon emission in key sectors, which is crucial to managing climate-related financial risks and ensuring financial stability.

### Article 8 [Methods for Determination of the Total Amount of Allowances and Allowances Allocation]

**The PRI suggests that the competent department of the State Council for ecology and environment should introduce the auction of carbon emission allowances and announce a target 2030 floor price of $60 per tonne of $CO_2$.**

The introduction of the auctioning of the allowances will establish a floor carbon price for the Chinese ETS market. This is necessary because it creates greater predictability for companies and investors in direction of Chinese energy policy.

**The PRI recommends that this article clarify whether the "total amount of carbon emission allowances" is an intensity-based cap or an absolute cap on emissions.** By giving clear policy signals to the market, especially to investors, it helps to avoid ambiguity in key concepts.

### Article 20 [Risk Prevention and Control]

**The PRI recommends the introduction of a "market stability reserve" mechanism** to regulate the risk of oversupply of carbon allowances and plunges in carbon price due to market volatility, and therefore improving the resilience of the national ETS.

### Article 21 [Carbon Emission Government Fund]

**The PRI recommends that the purpose of the fund should be extended to support "climate change mitigation, climate adaptation, and just transition".**