Taking The Pulse

Insights on Climate Developments in China

May 2024

Welcome to Taking the Pulse!

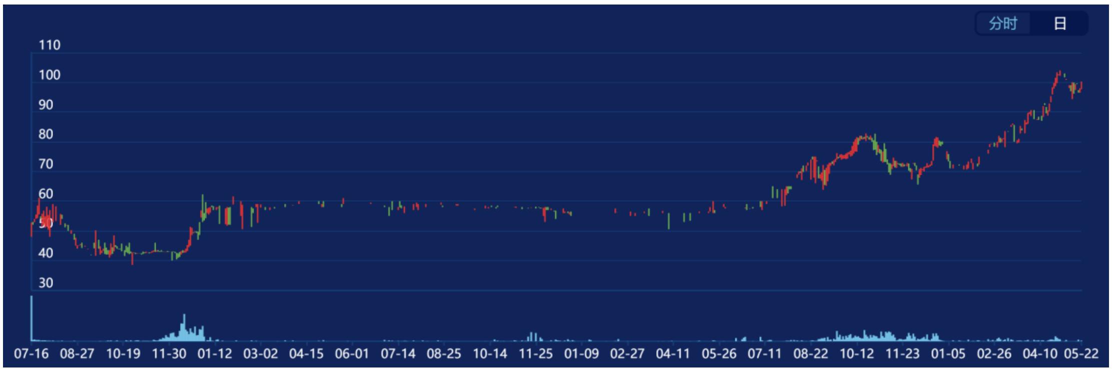
Taking the Pulse (TTP) provides the global climate community with access to the latest thinking by Chinese policy experts and industry insiders on the low-carbon transition.

In May, growing accusations of overcapacity in China's clean energy sector sparked a flurry of reaction in the Chinese media, with some voicing opposition and others expressing concern. And after years of effort, the light seems to be shining on the adoption of China's latest draft energy law. But first, the dormant carbon market is becoming more active as the carbon price rises to historically high levels.

In Focus: Price Up, Allowance Down, China's Carbon Market Moves into High Gear

Since its launch on 16 July 2021, China's national carbon emissions trading market (national carbon market), the largest of its kind in the world in terms of covered emissions, has kept carbon prices below 60 yuan per ton on average for a long time. Industry experts have pinpointed issues like the fact that at present the market only covers electricity production, uneven market trading activities, and lax supervision and penalties as some of the key factors behind the persistently low carbon prices and the lack of market dynamism. Since the first quarter of this year, however, Chinese carbon prices have been rising steadily. After breaking through the 100 yuan per ton mark on 24 April, the national carbon market has maintained high prices throughout May. Several financial experts anticipate that carbon prices will continue to rise in the short term.

The comprehensive market chart shows a periodic increase in carbon prices (represented by the trend of the green and red columns above) and trading volumes (represented by the blue columns below) towards the end of the compliance periods (by 31 December 2021 for the first period and by 31 December 2023 for the second).



Composite Carbon Price on China's National Carbon Market from 16th July 2021 to 22th May 2024.
For specific data, please visit Shanghai Environment and Energy Exchange

- **The current liveliness in carbon trading reflets the market's proactive response to the anticipated imbalance between carbon reduction supply and demand.**

On the supply side, there are concerns about the tightening of allowances in the mandatory market and the limited availability of carbon credits - known as China Certified Emission Reduction (CCER), which can be used to offset up to 5% of the carbon allowance - in the voluntary market. According to data released by the Guangzhou Emissions Exchange, around 77 million tons of CCERs have been issued up to 17 May 2024, with no increase since the restart of the CCER voluntary market on January 22. However, in the first compliance period, 32.73 million tons of CCERs have already been used. Analysts estimate that even without new industries joining the market, the national demand for CCERs in 2024 could reach about 100 million tons.

On the demand side, market expansion signals are driving trading activity. In April, the Ministry of Ecology and Environment issued a notice on soliciting opinions on the guidelines for the calculation, reporting and verification of green gas emissions for cement clinker production, following similar documents for the aluminum smelting industry in March. This has been seen as preparation for including these energy-intensive sectors in the carbon market. Song Yutong, analyst from the London Stock Exchange Group, suggests that due to uncertainties in allowance distribution for newly added industries after the foreseeable market expansion, some market players are purchasing carbon allowance in advance to avoid steep price rises before the deadline of the next compliance period.

On closer analysis, apart from the direct influence of market anticipation, the dual thrust of domestic policy and international influences seems to be the driving force behind the current momentum after the lukewarm performance of the last two compliance periods.

- **At the domestic level, strategic top-level planning is guiding the refinement of the carbon market mechanism.**

The Interim Regulations for the Management of Carbon Emission Trading (Regulations), which came into force on 1 May, proposed the gradual introduction of paid allowances in combination with free allowances. Moreover, the Regulations not only enhance market oversight but also specify and intensify penalties for various illegal activities, including falsification of data and reports, creating a healthier trading environment.

Professor Zhang Xiliang, head of the expert group on China's national carbon market design, predicts in an interview with Caixin, “Hopefully, by the end of the 14th Five-Year Plan (2021-2025) or the beginning of the 15th Five-Year Plan (2026-2030), the distribution method of paid allowances will be introduced in the industries covered by the national carbon market.” He highlighted in the same interview the necessity for carbon market development to align consistently with the national “dual carbon” goals in both pace and direction.

- **On the global stage, the implementation of carbon tariffs and the evolving international carbon market pose uncertainties for the development of China’s national carbon market.**

Topping the list is the EU's Carbon Border Adjustment Mechanism (CBAM). With CBAM's transition period ending in December 2025, there's little time left for Chinese companies to adapt. Liu Peizhong, researcher from the Bank of China Research Institute highlighted concerns over challenges to data security in China's relevant sectors posed by carbon tariffs. Liu also raises issues on China’s role in global carbon market trading, pointing out the absence of China in setting international emission data standards and the effect of varying industry coverage in existing carbon markets.

Meanwhile, the development of the international carbon market offers valuable experience for China's own market construction. Drawing from the EU's steel emission control practices, in a recent article, experts from the National Center for Climate Change Strategy and International Cooperation (NCSC) advocate for the proactive establishment of a multi-tiered carbon market and the swift integration of the steel sector into the national carbon market.

> In case you missed it: in last autumn’s TTP newsletter, we’ve gathered Chinese experts’ insights on CBAM.

- **The road to a mature and robust carbon market is still long and arduous.**

In comparison to the EU's carbon market, China's carbon market started relatively late and has been progressing at a slower pace. Consequently, numerous issues remain unresolved, and mechanisms require further refinement.

A recent analysis in the *Tsinghua Financial Review* identified several key challenges facing China's carbon market. First, its ambiguous international positioning limits its influence on global carbon pricing. Second, the carbon market mechanism needs to be better aligned with other low-carbon policies. In addition, the financial characteristics of the national carbon market remain unclear, hampering effective financial support. Finally, the management systems for carbon assets in major emission units need to be improved.

The recent surge in carbon prices signals a new phase of vibrant growth and expansion in China's national carbon market. However, Ren Daming, researcher at Beijing News' Zero Carbon Research Institute, notes that current carbon prices still lag significantly behind the social marginal abatement cost (which is 260 yuan per ton according to a report published in 2021). Strengthening the constraining function of carbon pricing within the carbon market is crucial to catalyzing the CCER market.

Under the pressure of carbon tariffs and the development of the international market, how to synergize the development of China's carbon market with the dual carbon targets without damaging the enthusiasm of market participants remains a prominent challenge to be overcome.

Sources of the Expert Views Cited in This Newsletter:

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China Power Energy Management: CCER Restarting Requires Synergize of Electricity and Carbon
China Times: Carbon price surges past historic high amid capacity expansion expectations, can it reach new highs in the future?
Cai Xin Weekly: China's Carbon Market Expansion on the Horizon
Financial News: Carbon Tariffs On the Way, China's Carbon Market Needs Imminent Improvement
NCSC: How Does the EU Control Steel Carbon Emissions through the Carbon Market?
Tsinghua Financial Review: Study on Pathways to Deepen Carbon Markets in the Context of the National-Regional Dual-Track Mechanisms
The Beijing News: Can a Rising Carbon Price Accelerate the Energy Transition?

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- **Climate-Trade Nexus |** Tariffs on Chinese-made EVs will increase pressure on both foreign and domestic automakers in China.
- **Energy Law |** China's latest Energy Law draft addresses some persistent issues in energy development but needs to be more practical.
- **Overcapacity |** To prevent overcapacity from becoming a reality, companies need to proactively prepare for external uncertainties.

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