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ESG Series – Carbon credits and carbon trading

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Climate change has been impacting our daily lives notably in the last few years as we are witnessing extreme weather conditions such as heavy rain, floods, and heatwaves at a global scale.

To limit global warming, many countries, companies, and world leaders are committed to achieving net-zero carbon dioxide emissions by 2050. In this article, we will discuss the basic framework and development of carbon credits and markets in the world and how it can help slow down climate change. We will also discuss some of the current energy saving and renewable energy measures taken in Hong Kong to reduce carbon emission.

Carbon credits and how it can slow down climate change

In general, a carbon credit is a permit that allows a company that holds it to emit up to a certain amount of carbon dioxide or other greenhouse gases. The purpose is to limit the extent of pollution caused by emission of carbon dioxide or other greenhouse gases. Further, the government may lower the number of permit levels each year thus lowering the total emission caps. Companies are therefore motivated to invest in clean technologies.

In a "cap-and-trade" system, the government issues a limited number of annual permits that allow companies to emit a certain amount of carbon dioxide. The total amount permitted is the "cap" on emission. Companies are taxed or fined if they produce a higher level of emissions than their permits allow.

When this system is applied to the commercial world, companies are encouraged to reduce carbon emission so that they may sell any excessive carbon credits to other companies which have not yet caught up with the carbon reduction standards. Despite the investments made on environmental protection, companies may off-set such investments or even make profits from selling carbon credits. That provides a

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more measurable incentive to the commercial sector in making contributions to slow down climate change.

UNFCCC and Kyoto Protocol

United Nations Framework Convention on Climate Change (UNFCCCs) and Kyoto Protocol play important roles in emission reduction. The UNFCCC sets out commitments by its parties (which include both developed and developing countries) to reduce climate change. The Kyoto Protocol is a protocol to the UNFCCC that imposes emission reduction targets on developed country parties. In general, emission reduction targets under the Kyoto Protocol can be met through:

a. International Emissions Trading which allows developed countries to trade carbon credits;

b. Clean Development Mechanism which allows developed countries to carry out projects to reduce emissions in developing countries, generating carbon credits; or

c. Joint Implementation which allows developed countries to carry out emission reduction projects in other developed countries.

Primary and secondary carbon markets

Carbon credits have a primary and a secondary market each with a different focus. A primary carbon market involves obtaining carbon credits from the development of emission reduction projects. A secondary market deals with trading of carbon credits as investments.

The secondary market mainly consists of two groups of buyers which are (i) entities which use emission allowance attached to the carbon credits to comply with emission control requirements under international or domestic legislation and (ii) banks and investment firms which deals with carbon credits as part of their ordinary course of business like how they trade other commodities.

Compliance markets and voluntary markets

Generally, there are two types of carbon markets. Compliance markets are created and regulated by mandatory national, regional, or international carbon reduction regimes, and are used by entities which by law have to account for their carbon emissions. Voluntary markets allow companies to trade carbon credits on a voluntary basis.

On 16 July 2021, Mainland China's carbon trading officially kicked off at the Shanghai Environment & Energy Exchange. Mainland China's carbon trading market is overseen by the Ministry of Ecology and Environment. China has aimed to strengthen its 2030 climate target, hit peak emissions before 2030 and achieve carbon neutrality before 2060.

Carbon market opportunities in Hong Kong

On 15 July 2021, the Green and Sustainable Finance Cross-Agency Steering Group, which

consists of the Hong Kong Monetary Authority, Securities and Futures Commission (SFC), Environment Bureau, Financial Services and the Treasury Bureau, Hong Kong Exchanges and Clearing Limited (HKEx), Insurance Authority and the Mandatory Provident Fund Schemes Authority, announced the next steps to advance Hong Kong's green and sustainable finance strategy in particular climate-related disclosures and sustainability reporting, carbon market opportunities and the launch of the new Centre for Green and Sustainable Finance.

The group is seeking to set up a Carbon Market Work Stream co-chaired by the SFC and HKEx to assess the feasibility of developing Hong Kong as a regional carbon trading centre to strengthen collaboration in the Guangdong-Hong Kong-Macao Greater Bay Area. The work stream will actively explore opportunities presented by both the "cap-and-trade" compliance market and the voluntary carbon market in China and overseas.[1]

Hong Kong's initiatives in promoting renewable energy through certificates and payments

The Hong Kong government is promoting the uptake of renewable and low-carbon electricity generation technologies and the offset of carbon footprint by introducing the following schemes:

The Renewable Energy Certificates Scheme[2]

This is an important voluntary market-based initiative introduced by the Hong Kong government and the two Hong Kong power companies, as to promote the development of renewable energy and achieve Hong Kong's carbon-reduction target by 2050. Under this scheme, renewable energy certificates are sold by the power companies for units of electricity from renewable energy sources so that buyers can claim their operation or activities are carbon-free. Each renewable energy certificate represents a certain volume of electricity from local renewable sources (e.g. solar, wind and landfill gas generated at home by local power utilities or purchased from green project owners).

Renewable Energy Feed-in Tariff (FiT)[3]

The private sector (including individuals) can take part in the scheme by installing solar and/or wind power renewable energy systems on their premises. Once a system is successfully connected to the power grid, the power company will buy the electricity generated by system at a FiT rate and the FiT payments will be reflected in the electricity bills. Currently, the FiT rates under this scheme are: HK$5 for ≤10kW; HK$4 for >10kW to ≤200kW; and HK$3 for >200kW to ≤1MW. The above FiT rates will be reviewed annually, and FiT will be offered throughout the project life of the

[1] https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/07/20210715-4/

[2] https://www.gov.hk/en/residents/environment/renewable/certificates.htm

[3] https://www.gov.hk/en/residents/environment/renewable/feedintariff.htm

renewable energy system until the end of 2033. Electricity generated after 2033 will belong to the owner of the renewable energy system.

Takeaway

We are seeing many jurisdictions including Mainland China transitioning steadily into green, low-emission and climate-resilient economies and as a result we expect the global carbon markets to grow. Hong Kong, being one of the most important financial centers in the world, is in a unique position to play a strategic role as China's gateway and mobiliser of capital and possibly an important carbon market to facilitate the national carbon neutrality goal.

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