

**HKEx Consultation Paper, CER Futures**  
**Comments of Climate Focus and Mallesons Stephen Jaques**  
**31 August 2009**

**1 Do you think CERs should be the core carbon emission product to pursue in Hong Kong now or in a few years time?**

Since the completion of the HKEx emissions products study in late 2007, it has become far more apparent that in the absence of mandatory emissions reduction obligations (whether through cap and trade schemes or carbon budgets) imposed by law or the threat of imminent law to create a demand for carbon allowances or credits, regions or countries with no such legal regime or impending regime have created little short term economic or commercial incentive for market players in those places to set up carbon exchanges. Rather, as is observed in the consultation paper, the CER market has been dominated by demand side participants from Europe or those that eventually trade with European participants. That said, a key object of introducing a CER future or other carbon future now is to position a key exchange such as HKEx strategically for the medium to long term. The main aim being to build direct experience in carbon futures and other exchange tradeable carbon asset derivatives, thereby giving HKEx practical insight as to how carbon trading may be best adapted for Asia in a key Asian international finance centre.

In the last 6-12 months, there have been rapid developments around the world<sup>1</sup> to move countries to low carbon economies (note Hong Kong Chief Executive Policy Address, October 2008, page 95<sup>2</sup>). Policy and legal frameworks to achieve low carbon economies are far broader than that to create an emissions trading scheme, as unlike the latter, low carbon policies and law address issues and objectives across the entire economy and its different sectors, rather than a market mechanism that covers a more limited range of participants. Of particular interest to Hong Kong is the determination China is now showing to develop and move to a low carbon economy<sup>3</sup>. Chinese policy makers have very recently been talking about preparing dedicated policies and laws on climate change to meet low carbon goals. Carbon trading and exchanges, low carbon development zones, carbon budgets and carbon taxes in China have all been raised in the reports and policy recommendations by leading Chinese researchers and policy think tanks. All this gives rise to the very exciting and interesting prospect of the creation of domestic demand for carbon credits within China. It is this opportunity that HKEx should now move to take advantage of.

To date, European Allowances and CERs are the core emission products that are traded in exchanges around the world. At the time of the HKEx carbon market study, we emphasized HKEx's preferred access to CERs through its close relations with Mainland China. Until now, China has been the main supplier of CERs, being responsible for over half of CERs generated to date. However, China's dominant position in the CER market is likely to change as China may be on its way to graduate from the status of eligible CDM host countries, at least in certain sectors. Anticipating possible future changes, the Chinese DNA issues CDM host country approval letters with expiration date of 2012. While China may lose its role as the main CER supplier, the CDM as such is likely to remain the main source of carbon credits from the developing world in the short to medium term. New concepts are under discussion such as creditable Nationally Appropriate Mitigation Action (NAMAs)<sup>4</sup>. These are still

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<sup>1</sup> See 'UK low carbon economy transition plan', July 2009:

[http://www.decc.gov.uk/en/content/cms/publications/lc\\_trans\\_plan/lc\\_trans\\_plan.aspx](http://www.decc.gov.uk/en/content/cms/publications/lc_trans_plan/lc_trans_plan.aspx)

<sup>2</sup> <http://www.policyaddress.gov.hk/08-09/eng/policy.html>

<sup>3</sup> See 'China Sustainable Development Strategy Report 2009 - China's Approach Towards a Low Carbon Future', Chinese Academy of Sciences, March 2009 and '2050 China Energy and CO2 Emissions Report', Energy Research Institute of the National Development and Reform Commission, July 2009

<sup>4</sup> See Bali Road Map: [http://unfccc.int/files/meetings/cop\\_13/application/pdf/cp\\_bali\\_action.pdf](http://unfccc.int/files/meetings/cop_13/application/pdf/cp_bali_action.pdf)

highly controversial and no practical experience exists. Even if NAMAs are agreed in principle at Copenhagen, it will still be a long way until they will result in credits. Still, in the long term NAMA related credits as well as allowances handed out in new regional emission trading schemes following the example of the EU ETS may generate the largest volumes of credits. The CDM is likely to prevail as a concept after Copenhagen yet its role may be diminished for fast emerging economies.

Accordingly:

- CER still offer a good entry point of activities. However, HKEx should watch developments closely and seek out opportunities that arise out of NAMAs and domestic emission trading schemes
- proximity to Mainland China is still of interest even if Chinese CER supply is drying up. Apart from being a CER supplier, HKEx can tap into investment potential of Chinese trading participants
- rest of Asia continues to be a relevant source of CERs

**2 Under existing market conditions, in what way can Hong Kong add value to the business process of the CER market and attract carbon emissions trading participants to the Hong Kong marketplace?**

In addition to the above, HKEx should lend further support to emerging arrangements to allow Hong Kong companies/investors to develop and 100% own CDM projects in China (until the arrangements are operational, Hong Kong investors can only own up to 49% of a Chinese CDM project in joint venture with a Mainland Chinese partner). HKEx should also consider facilitating auctions of CERs in Hong Kong (from Chinese and other Asian CDM projects), to attract more international carbon market players to do business and set up in Hong Kong.

**What are the success factors for Hong Kong to develop a commercially viable CER trading platform that can attract trading activities and develop trading liquidity?**

Key carbon trading players are eager to get into this market. HKEx is ideally placed to partner with one of the pioneers. A platform should be developed in partnership with a leading carbon exchange, with HKEx retaining control over any joint venture entity. The platform should be user friendly and easily adapted to trade other carbon and pollution assets in the event that CER trading thins or diminishes. We also consider that the support of the Hong Kong and Mainland Chinese Governments will be important.

**Do you think Hong Kong possesses the success factors? Please explain your views.**

Yes. HKEx has the resources and the clout to establish itself if it wishes. But it needs a dedicated effort and the help of an established and experienced partner.

**3 Do you consider Hong Kong investing communities have sufficient knowledge in carbon emission trading and are they ready to participate in trading CER products? Please explain your view.**

The general level of awareness is low but leading Hong Kong companies are aware of the global carbon markets and do invest in the sale and purchase of CERs. However, with the exception of the aviation industry (Hong Kong airlines that fly into and out of Europe), there is no need for Hong Kong companies (unless they have subsidiaries that have obligations under the EU ETS) to purchase EU allowances or CERs. Accordingly, Hong Kong

companies that get involved in trading are entering the market to make profits by developing CDM projects that generate CERs which are then sold to financial intermediaries or compliance buyers directly. As such, there is an increasing level of sophistication shown by Hong Kong companies that have been forced to enter the carbon markets for compliance reasons but in the main because they have identified new business opportunities in China and other parts of Asia that are more easily accessible and leveraged from Hong Kong.

4 Not directly relevant to our firms but we are advisors to a number of financial intermediaries who are based in Hong Kong that actively trade carbon credits (CERs and VERs).

**5 Are there any other issues regarding the introduction of CER futures not mentioned in this consultation paper that we ought to consider? Please explain your views.**

The international carbon markets are in a period of rapid change, substantially caused by activities leading up to, during and after the Copenhagen climate conference in December this year. Further, as mentioned above, steps taken by countries such as the UK and China to move to low carbon economies will also fundamentally affect the carbon market and the types of products that may be most actively traded.

**6 Do you have other comments in relation to the overall development of emissions or pollutants trading markets in Hong Kong?**

Much depends on the Hong Kong Government providing the policy encouragement and support to create a low carbon economy in Hong Kong. Indeed, our view is that it is critical that the Hong Kong Government takes clear, comprehensive and decisive action to develop a low carbon economy for Hong Kong. Trading of emissions and other pollutants will be a key and necessary component of utilising markets to meet a range of low carbon objectives. Indeed, the engagement and mobilisation of the financial sector, with its vital role across sectors, will be essential to the success of a low carbon economy.

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