11. The Business of Linking Carbon Markets in Northeast Asia

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SUMMARY

THIS CHAPTER EXPLORES THE ROLE OF THE BUSINESS COMMUNITY in discussions on carbon market linkage in Northeast Asia. China, the Republic of Korea (hereafter Korea), and Japan have witnessed significant developments in their domestic market-based policies during this decade and are expected to be among the most active jurisdictions in this space going forward. If the three countries are to explore options to link their respective carbon markets in the future, the business community will be central to the discussion.

This chapter also takes stock of recent developments with the aims of understanding what role the private sector plays in the discussion on linkages and of reflecting on the possible way forward.

To this end, the paper starts by offering a brief overview of the latest developments in Northeast Asian carbon markets, with a particular focus on China, Korea, and Japan. The paper also analyzes the engagement of the private sector in carbon markets and explores levels of business support for carbon market linkage.

After reviewing the potential for carbon market linkage under the Paris Agreement of the United Nations Framework Convention on Climate Change (UNFCCC), the paper looks specifically at the prospects for carbon market linkage in Northeast Asia and at what role the private sector can play in this regard.

LATEST DEVELOPMENTS IN NORTHEAST ASIA CARBON MARKETS

China, Korea, and Japan have witnessed significant developments in their domestic market-based policies during the past decade, and are expected to be among the most active jurisdictions in this space going forward. Korea launched the first-ever nationwide emissions trading system (ETS) in Northeast Asia in January 2015. The system is now entering its second phase of operations. China has experimented with several ETS pilot systems since 2013 and announced the launch of a nationwide system in December 2017. Japan, despite not having a national ETS in place, has been experimenting with different forms of market-based climate policies, ranging from city-level ETSs to innovative and ambitious international crediting mechanisms.

These developments are addressed more in detail elsewhere in this volume and pose questions about the region's future carbon market trajectory. A maturation of these recently launched policy frameworks will be needed in each respective country, and in the coming years more systems are expected to arise in other countries in the region—likely including Singapore, Thailand, and Vietnam. But the most interesting question is whether Northeast Asian systems will continue to operate in isolation or consider possible forms of collaboration and linkage. This chapter explores what role the business community could play in this process.

BUSINESS ENGAGEMENT IN CARBON MARKETS AND THE BUSINESS CASE FOR LINKING CARBON MARKETS

The business community can be an active advocate for the implementation of emissions trading systems and for the use of linked carbon markets as a way to reduce emissions. The International Emissions Trading Association (IETA) brings together more than 130 businesses around the world in support of the adoption of carbon markets worldwide and actively advocates for the linking of different systems. Ahead of COP21, the landmark conference where world's leaders adopted the Paris Agreement, IETA, together with 19 other business associations estimated to collectively represent more than 100,000 business entities,[1] issued a letter on the importance of including provisions for the establishment of international carbon markets in the Paris Agreement.[2] Individual statements from some of these organizations followed the letter.[3] The strong push from the private sector was one of the drivers behind the inclusion of market provisions in the Paris Agreement, which is analyzed later in this chapter.

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The reason behind this support was that having market provisions in the Paris Agreement was seen as a key enabler of carbon market linkage. The benefits that can arise from linked carbon market systems were highlighted in some of the aforementioned statements from the business community:

- The creation of a level playing field and prevention of competitive distortions,
- The avoidance of carbon leakage,
- The ability to reduce emissions at lower costs,
- The development of comparable policy frameworks leading to more consistent operating environments, and
- Having allowances that are fungible in multiple systems.

IETA members have specifically and through written testimony[4] also highlighted linkage benefits such as the following:

- The stabilization of carbon prices,
- Increasing liquidity,
- New cost efficiency opportunities to be identified beyond borders, and
- A step toward the implementation of an international framework for climate action.

CARBON MARKET LINKAGE, THE PARIS AGREEMENT, AND THE ROLE OF THE PRIVATE SECTOR

Carbon market linkage can take different forms and can be implemented through different political processes. Some of these processes are explored elsewhere in this volume; here, we focus on the international framework that will regulate cross-boundary climate action in the post-2020 period: the Paris Agreement.

The linking of two emissions trading systems can of course happen in a bilateral manner between two countries. Those two countries are free to set the rules they prefer for that linkage to happen and operate under, but if the emissions reductions achieved under the linking arrangement are to be recognized as part of the fulfillment of the two countries' nationally determined contributions under the Paris Agreement, the linked system has to abide by the rules and requirements set out by the Agreement itself.

Given that countries in Northeast Asia are at different stages in the implementation of their domestic policies, a fully fledged carbon market linkage is not assured and if implemented will require years of collaborative effort.

The Paris Agreement, adopted in December 2015 and entered into force in November 2016, contains provisions that can facilitate the linkage of domestic carbon markets. These provisions, which are in line with those the business community advocated for in the run-up to COP21, can be found in Article 6 of the Agreement.[5]

Article 6.2, in particular, allows Parties to "engage on a voluntary basis in cooperative approaches that involve the use of internationally transferred mitigation outcomes (ITMOs) towards nationally determined contributions."[6] Over the past two years, UNFCCC negotiations have focused on defining the rules for the operationalization of the Paris Agreement, commonly referred to as the "Paris Rulebook," in a process that is expected to be concluded at COP24, taking place in December 2018.

The exact definition of an ITMO and the exact operationalization of Article 6.2 are thus still being defined. Nevertheless, when reading Article 6.2, it is quite easy to imagine one of its most obvious practical applications as the linkage of multiple emissions trading systems. Much of the potential for carbon market linkage under the Paris Agreement will therefore depend on how Article 6, as well as the Paris Agreement as a whole, will be operationalized in the Paris Rulebook.

Another important aspect not yet defined is the role of the private sector in Article 6 operations. Article 6.3 hints at this issue by stating, "The use of internationally transferred mitigation outcomes to achieve nationally determined contributions under this Agreement shall be voluntary and authorized by participating Parties," meaning that Parties, obviously, are ultimately responsible for the application of Article 6.2.[7] What remains to be decided is how, for example in the case of a linked system, this authorization will be transferred to the compliance entities and the other players in the linked carbon market.

The definition of these aspects and their application in the real world potentially carry deep implications on the functioning and efficiency of a linked market. The business community is therefore monitoring this issue closely, as rules are being defined and are expected to be delivered by the end of 2018.

The key issue, from the perspective of business, is to make sure that the rules are drafted in such a way to allow open and optimized private sector participation in these mechanisms. This will also impact the effectiveness of future linked systems. This mirrors businesses' desire for continuity and access to low-cost opportunities in domestic contexts and has been laid out in a comprehensive vision for the implementation of Article 6.[8]

PROSPECTS FOR CARBON MARKET LINKAGE IN NORTHEAST ASIA AND THE ROLE OF THE PRIVATE SECTOR

Northeast Asia offers exciting opportunities for future carbon market linkage as regional domestic markets continue to mature. Linking is in most cases a lengthy process. Given that countries in Northeast Asia are at different stages in the implementation of their domestic policies, a fully fledged carbon market linkage is not assured and if implemented will require years of collaborative effort.

China, Korea, and Japan will very likely prioritize the implementation, stabilization, and optimization of their domestic systems before starting the linking process. Nevertheless, while domestic developments are progressing, a number of international initiatives with relevant implications for linking are also moving ahead:

- China, Korea, and Japan are involved in an annual Trilateral Summit, which addresses market linkage and collaboration among other topics.[9]
- Japan and Korea are signatories to the Ministerial Declaration on Carbon Markets, led by New Zealand.[10]
- Japan is part of, and has chaired, the G7 Carbon Market Platform, which is also open to other countries willing to participate.[11]
- Japan and China are participating, in different capacities, in the Word Bank's Partnership for Market Readiness.[12]
- Korea and Japan participate in the Asia Pacific Carbon Market Roundtable, facilitated by New Zealand.[13]
- China, Korea, and Japan are all involved at government, private sector, and epistemic levels in the track II project *Toward a Northeast Asia Carbon Market* led by the Asia Society Policy Institute.

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These active discussions are a positive sign that key stakeholders in Northeast Asia are considering carbon market linkage in detail and seeking pathways toward its execution. The business community, which both impacts and is impacted by carbon market policies throughout the region, needs to be involved across policy-making processes.

The risk of policy failure if the private sector is not aware of the intentions of policy makers and consulted on policy construction can be extremely high.[14] The Korean ETS (KETS) offers an example, with one of the main reasons for the lack of liquidity in the market being the lack of trust, among covered entities, in the market regulator. The problem concerns both that compliance entities believed the initial allocation levels were inadequate, leading to several lawsuits, and the lack of transparency on future allocation levels—two problems that could have been solved through an adequate involvement of the private sector in the policy-making process and with better dialogue and information sharing. This has been compounded in Korea by the vacillation of the carbon market policy platform from the Ministry of Environment (MOE) to the Ministry of Strategy and Finance (MOSF) and most recently back to the MOE.

The private sector can help governments enrich the quality of the information available to them, which in turn translates to better and more informed policy making. The most widespread practice for stakeholder involvements to date are calls for oral or written input, which has become standard practice in many jurisdictions. However, governments have come to realize that other practices can allow for a deeper involvement of the private sector. These include structured dialogues, informal expert discussions, and active workshops designed to foster constructive, problem-solving, dialogue. These best practices and recommendations are valid not only for the UNFCCC process but also apply to domestic policy making and throughout the aforementioned regional discussion fora.

The three key business arguments for linking—competitiveness, market functioning, and cost effectiveness—are highly relevant in the Northeast Asia context.

Looking more closely at the linkage discussion in Northeast Asia, an optimal involvement of the business community in the policy-making process can deliver tangible benefits and can help facilitate the process. While it is still unclear what form a future carbon market linkage in Northeast Asia can take, some key considerations are universally applicable. Engaging with the business community can do the following:

- Help build consensus around the carbon market linkage. Given the support for linkage outlined previously, securing an optimal involvement and engagement of the private sector in the process can help ensure that the latter becomes a strong and proactive ally and advocate.
- Help facilitate the process. The aforementioned support in the private sector can, in turn, enhance the acceptability and strength of a policy. This is especially true in the case of a carbon market linkage, as the private sector is the key player in this kind of policy.
- Bring important experiences and lessons learned. Some businesses involved in a linkage discussion in Northeast Asia are likely to have gained relevant experiences in other jurisdictions, for instance, as participants in the Western Climate Initiative (WCI) linked system or in the EU ETS-Norway link. These businesses will be able to share their insights on what worked and what did not in other linked markets. These experiences and lessons can be used to inform the policy-making process and will benefit both policy makers and the private sector, as well as helping deliver better and more durable policies.

The aforementioned experiences and lessons learned, combined with feedback from the business community on the key design options of the carbon market linkage, are essential to make sure that the linkage is designed in an optimal way, and in a manner that maximizes the support of the private sector.

To maximize benefits, business engagement should be kept at the forefront throughout the process, and not only on sporadic occasions, starting with the early stages of the discussions on international collaborations and linking.

China, Korea, and Japan are interlinked by long-standing business and trading relations, and many private sector actors operate across all jurisdictions. They are major trading partners and many companies

have operations in neighboring jurisdictions.[15] These are ideal conditions for carbon market linkage to emerge, both because existing trade relations can facilitate the creation of the linkage and because the benefits of linking are maximized, especially concerning international competitiveness distortions and the harmonization of different systems.

The three key business arguments for linking—competitiveness, market functioning, and cost effectiveness—are highly relevant in the Northeast Asia context.

From a competitiveness perspective, having a linked system can help reduce the fear of competitive disadvantage compared to businesses operating in other countries in the region. This will be particularly beneficial for businesses in Korea, Japan, and China facing competitors in one of the other two countries. Linkage will result in a more level playing field across the countries involved and will reduce distortions, which in turn will mitigate concerns about ambitious climate policies.

From a market functioning perspective, a well-designed linkage can improve the functioning and effectiveness of domestic systems by improving liquidity, which is a key shared concern throughout the region, and by widening the market. Moreover, linking often also implies a harmonization of the systems involved, with a consequent linearization of the rules, which will be beneficial for multinational businesses operating in China, Korea, and Japan.

From a cost-effectiveness perspective, linkage ensures access to a larger pool of emissions reduction opportunities, which can lower overall abatement costs compared to domestic action alone. This is of particular importance for countries such as Korea and Japan, which have reported in their nationally determined contributions that they plan to achieve part of the mitigation effort beyond national borders.

CONCLUSIONS AND THE WAY FORWARD

Widely held views in the business community on the value and potential of linking carbon markets are particularly salient to the Northeast Asian context.

The business community can play a key role in making such carbon market linkage a reality. If correctly involved, the business community can act as a key advocate for carbon market linkage and can help facilitate the process. Moreover, by bringing its unique experiences and insights to the table, the private sector can help design well-functioning and long-lasting policies.

Some conditions are essential for this to happen. It is vital to ensure adequate government-to-business interaction at multiple steps of the policy-making process. The private sector should be adequately informed about future policy developments and policy makers' intentions. The business community should be consulted and actively engaged both to provide feedback on policy proposals and to be able to leverage the relevant experiences and lessons learned business has to offer.

ENDNOTES

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