The Kyoto Protocol comes to Hong Kong

By Arthur McInnis

On May 28 this year China agreed to the extension of the Kyoto Protocol to Hong Kong marking what may be a major turning point in how we deal with green gases. I say 'may' because reductions for us are not mandatory. Hong Kong will follow the Protocol 'in the shade of' China' which has been classified as a developing country, one of those listed outside the Annex 1 of developed countries. For developed countries reductions in green house gases are supposed to be mandatory, though this does not occur until the Protocol enters into force. Oddly, last August the PRC Government had decided that the Protocol would not apply to Hong Kong and Macau. This followed the PRC's original signing on May 29 five years ago and subsequent approval last August. Let me share some background on it.

United Nations Framework Convention on Climate Change (UNFCCC)

First of all it is worth noting that the Kyoto Protocol is simply an addendum to an earlier Convention, the UNFCCC, that signed in 1992 and came into force in 1994. It was really the first major international initiative in the area of greenhouse gas mitigation. It is supposed to stabilise atmospheric levels of greenhouse gases and keep us alive on this planet. So far so good. But, there is one important thing missing once again. The Kyoto Protocol, which is a key part of the Convention, has not yet come into force. In fact, it will not become effective until at least 55 parties accounting for at least 55 per cent of the carbon dioxide emissions that were released in 1990 have ratified it. Views differ on whether those thresholds will be met anytime soon.

What is Emissions Trading

Essentially it evolves from a system that restricts the aggregate allowable amount of a pollutant and allows market forces to continually move those emissions, which are allowed, to their highest value uses. So for example, say you are a company with emissions but are able to reduce them (to below your allowable emissions level) at a relatively low cost then you can sell your unused rights to another company with a higher cost of emissions reduction. In simple terms, the underlying rationale is to provide companies et cetera with the flexibility to determine the most cost-effective means to reduce their emissions.

How are greenhouse gases traded

Emissions trading, in the greenhouse gas markets, is often referred to as Emissions Reductions Trading. There are three basic structures, which will be very familiar to securities and derivatives lawyers. The structures are:

- Immediate Settlement – where the terms of a bid and offer are set on the trade date with delivery and payment occurring in a standard timeframe shortly thereafter.
- Forward Settlement – where the terms are set on the trade date, but delivery and payment are deferred to a future date specified at the time of the trade.
- Options – in which the parties buy or sell the option whether or not to enter into a specified cash transaction at the strike date. The best examples are call and put options.

The difference is that you are not buying and selling shares but your right to pollute.

The Kyoto Protocol

The Protocol lays down a time frame for emissions reduction activities as well as international emissions trading initiatives. It splits countries up somewhat: developed and developing. For countries listed in Annex 1 to the UNFCCC six options are given for them to meet their individual emissions reduction targets:

- Policies and Measures, which would include adoption and enforcement of new laws and regulations.
- Sinks Enhancement, what could otherwise be called natural features of the climate system and which you might better recognise as land, plants and the oceans, which importantly can transfer greenhouse gases to other reservoirs.

Both Policies and Measures and Sinks Enhancement operate at the national level.

- Joint Fulfilment, as it implies.
- Joint Implementation, given the varying cost of reducing emissions within different countries, credits from joint implementation emissions reduction projects can be transferred between different Annex 1 countries under article 6 of the Protocol. For instance, if a French company invests in an emissions reduction project in Russia, the credits for the emissions reduced could be allocated to the French company.
- Clean Development Mechanism, the Protocol acknowledges the fact that it may be more cost-effective for Annex 1 countries to reduce emissions in non-Annex 1 countries (developing countries). As such, Annex 1 countries are entitled to generate or purchase emissions reduction credits from projects undertaken by them within non-Annex 1 countries. This is my biggest point so far and I will argue later whether it could put Hong Kong in the Emissions Trading business.
- Emissions Trading, under the Protocol, is a so-called 'cap and trade' system, where a total amount of allowable emissions for all Annex 1 countries is agreed to – the cap. The scheme then allocates portions of the cap as emissions 'allowances' to each of the Annex 1 countries. Those Annex 1 countries which reduce their emissions below their allowances are then able to trade some part of the surplus allowances to other Annex 1 countries. Thus fairly straightforward in concept though unquestionably complex in operation.

These latter four means all operate at the international level and all but Joint Fulfilment are often described together as emissions trading or the 'Kyoto Flexibility Mechanisms'. A unique feature that all three mechanisms share is the 'supplementarity' requirement. Thus Annex 1 countries should be limited in the use of these mechanisms to help achieve their emissions reduction targets. Now, most of the targets will presumably be reached through domestic actions (Policies and Measures and Sinks Enhancement) and not be simply buying reductions from other nations.

Opportunities in Hong Kong and China

In China special laws on emissions trading have already been adopted in several provinces, including Jiangsu and Shanxi. Lately, China's first agreement on sulphur dioxide emissions (S02) trading by two power plants has been reached – Taicang Port Huanbao Power and Nanjing Xiaguan Power – in Jiangsu and will come into effect in July.

In Hong Kong the extension of the Protocol casts a new light on doing business here which may provide an edge over others in the region and could even result in Hong Kong becoming a true Emissions Trading centre, given its robust legal system and knowledge of how trading mechanisms generally work. The recent agreement between Hong Kong and China to enter into a Closer Economic Partnership may give this a boost as well. With any luck Hong Kong too should be able to attract enterprises from the Annex 1 developed countries precisely because many of them can be expected to exceed their allowable emissions level. Who knows, maybe we are even looking at a silver lining in what are sometimes brown clouds overhead.

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