Linking Emission Trading Schemes around the world: critical analysis and perspectives

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Outline of the presentation

- Linking ETSs as an opportunity
- Linking features and legal requirements
- Perspectives on linking options
- Beyond linking? The World Bank proposal of 'networking carbon markets'

Linking ETSs as an opportunity

Scope of the presentation

- The scope of the presentation is to illustrate the content of Deliverable D7.09, which focuses on linking Emission Trading Schemes (ETSs) around the world, as a viable opportunity for participating countries to increase the effectiveness of their own domestic or regional regimes.
- Deliverable D7.09 draws on the findings of Deliverable D7.08, which presented a critical assessment of the main lessons learnt and the emerging trends of the EU ETS as well as of other relevant ETS regimes.

Background scenario

- Great attention on climate change in the recent decades from the International Community, … currently experiencing a long lasting crisis of multilateralism.
- *“Escalation”* of disappointing outcomes from the international negotiations (COPs): great expectations, but nearly zero results (Bali, Poznan, Copenhagen, Cancun, Durban, Doha, Warsaw…).
- Realistic goal: proceeding on the negotiations with a view to achieving an global agreement at Paris 2015.

…a snapshot on the current state of art of UNFCCC negotiations

- Big deal!

…but: which results???

Looking forward a global agreement on climate change...

…a forecast on the possible (realistic) scenario

The ETSs as a viable option

- <u>Emission Trading Schemes (ETSs) are a viable option to fill the international negotiations' crisis and gaps.</u>
- Outlook on the short-medium term shows that ETSs are likely to proliferate and consolidate their role as a cost effective tool to deal with climate change.
- <u>Need of REGULATION</u>: there is a need to develop a set of harmonised rules to ensure the <u>coordination and linking</u> of ETSs around the world with the overarching goal of moving to a *low carbon economy* without allowing *wild trading.*

Linking ETSs as an opportunity

- Linking ETSs around the world may be a good opportunity to achieve various goals.
- In particular 'linking' may help to:

➢ overcome the current stalemate of international climate change negotiations;

and

➢ increase the effectiveness of the existing domestic or regional regimes.

Linking features
and legal requirements:
pros and cons
(or necessary and optional features)

Setting the regulatory framework for linking

- It is necessary to formally establish the ETS linkage by means of a proper legal act. This can done in 2 possible ways:

➢ <u>International Treaty</u>: foreseen by article 25 EU ETS Directive (eg: EU ETS and Australia CPM linking)

❖ greater formality, accountability, reliability and continuity over time, but less flexibility and stricter rules.

➢ <u>Memorandum of Understanding </u>(eg: foreseen by RGGI)

❖ greater flexibility, simpler structure and easier decision-making proces, but lower formality in legal force as compared to an International Treaty, higher risks of unilateral termination).

- Both types of international tools are effective means to set up the linkage, but both need further implementation measures taken at national level by the Parties.

Linking drivers

- The main drivers for linking ETSs are:
- Political commitment towards a common effort to fight against climate change;
- Pursuing higher cost-effectiveness in tackling climate change;
- Strengthening international cooperation with neighbouring or like-minded countries.

Linking pros

- Political pros: overcoming current stalemate of international climate change negotiations and pursue a more feasible option (end of top-down approach, but flexible bottom-up approach or combination of the two via a global agreement);
- Economic pros: providing a wider range of compliance opportunities to operators and ensuring more liquidity and stability to the market;
- Regulatory and administrative cons: spread best practices among ETS public & private actors.

Linking cons

- Partial loss of sovereignty for the Parties;
- Risk of negative effects on prices and behaviours from one ETS to the other;
- Loss of accountability and transparency;
- Difficulties in managing the ETSs;
- Risks of *race to the bottom*;

➢ Cons may be overcome by proper <u>regulation</u>!

Types of linking

- There are three main possible types of linking:

1. Unilateral direct linking

(i.e.: ETS A is linked unilaterally with ETS B; therefore ETS B allowances may be used within ETS A, but ETS A allowances may not be used within ETS B- eg: Australia CPM and EU ETS in first phase);

2. Bilateral or Multilateral direct linking

(i.e.: ETS A and ETS B are directly mutually linked therefore allowances from ETS A can be used within ETS B and viceversa- eg: Australia CPM and EU ETS in second phase);

3. Indirect linking

(i.e.: if ETS A is directly linked with ETS B and ETS B is directly linked with ETS C, then ETS A is indirectly linked with ETS C; or: if ETS A is directly linked with ETS B and ETS B is directly linked with the Kyoto Protocol CDM and JI -or other type of offset projects, then ETS A will also be indirectly linked with the Kyoto Protocol CDM and JI -or other type of offset programmes)

Linking ETSs: necessary and optional features

GHG EMISSIONS CAP	NECESSARY
MEASUREMENT, REPORTING AND VERIFICATION (MRV)	NECESSARY
ENFORCEMENT PROCEDURES	NECESSARY
ALLOWANCE TRACKING SYSTEM	NECESSARY
SCOPE	OPTIONAL
COMPLIANCE PERIODS	OPTIONAL
ALLOCATION METHOD	OPTIONAL
PRICE COLLARS (floors & ceilings)	NECESSARY
COST CONTAINMENTS MEASURES (banking & borrowing)	NECESSARY
LINKING WITH OFFSET PROJECTS	OPTIONAL
CARBON LEAKAGE RULES	OPTIONAL

Perspectives on linking options

The three linking options

- Identification of the options for linking EU ETS to the other selected ETS systems.
- The present research has focused on three main concrete options for linking:

1) a global single ETS;

2) a network of regional/domestic ETSs;

3) a linkage scheme (between interacting regional/domestic ETS blocks (through bilateral agreements).

A global single ETS

- One prerequisite for the establishment of a global single ETS is needed:

➢ Signing a global ETS agreement for:
  - ✓ establishing a global ETS regulator
  - ✓ adopting a set of worldwide shared rules

- Shortcoming: crisis of multilateralism
- Problems: 1) how to define a global cap?;

  2) how to allocate emissions allowances?

A network of regional/domestic ETSs

- The prerequisite is obviously the existence of an ETS in various countries

➢ It is necessary to reach an agreement between interested ETS countries for:
  - ✓ coordinating the regional/domestic ETSs
  - ✓ identifying minimum common standards

- Problems: 1) necessity to partially give up sovereignty;

  2) numerous and remarkable differences may be identified among the existing ETSs.

A linkage scheme between interacting ETSs

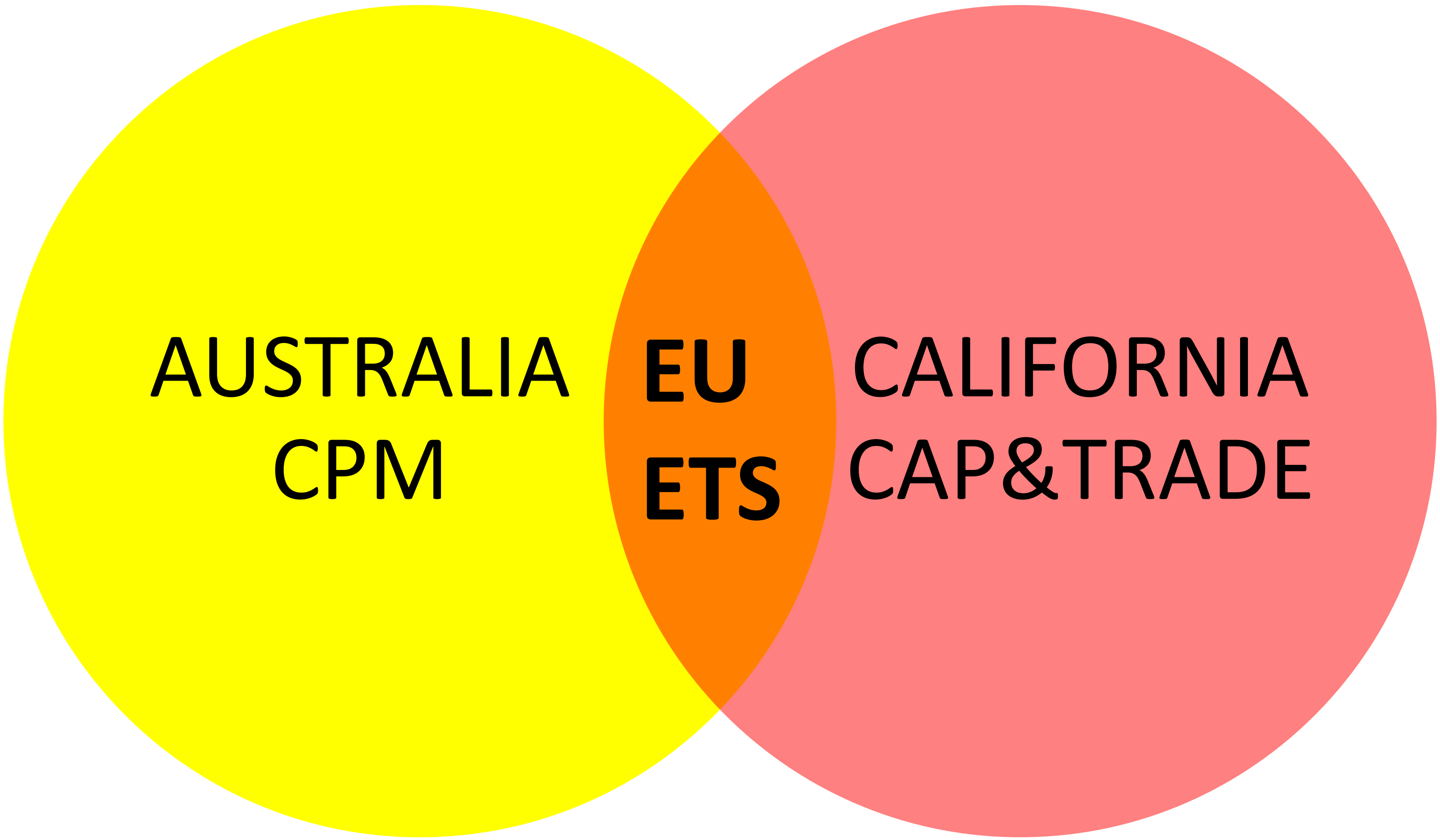
- Also in this case, the prerequisite is obviously the existence of an ETS in the countries involved
- ➢ It is necessary to reach one (or more) bilateral agreement(s) between interested ETS countries for:
  - ✓ coordinating their respective ETSs
  - ✓ identifying criteria for mutual recognition of allowances
- Problems: 1) high degree of mutual trust needed;

  2) strong political commitment required.

Three options as a *continuum*

- The three alternative options are meant to be read as a *continuum*...
- ➢ from the more advanced (option 1: global ETS)
- ➢ to the medium one (option 2: a network of regional/domestic ETSs)
- ➢ to the less advanced one (option 3: bilaterally interacting ETSs);
- Currently option 3 seems the most feasible one…
- However… times may change…

…if…for instance



Then…this could happen…

OPTION 1

(global ETS)

OPTION 2

(network of regional/domestic ETSs)

OPTION 3

(bilateral interacting ETSs)

Beyond linking? The World Bank proposal of ‘networking carbon markets’

- The World Bank recently proposed to connect carbon markets through independent rating agencies and systems (Sinha, 2013).
- Private rating agencies should rate environmental integrity and climate change mitigation value of carbon assets in the international markets and then convert ratings into carbon exchange rates.
- All international trading should be registered in an ‘International Settlement Platform’ acting as clearing house for the whole system.

The World Bank proposal: pros

- While linking with an ETS which has a inappropriate adequate verification systems may harm environmental integrity, the rating of carbon assets by independent agencies may preserve *environmental integrity*.
- While linking ETSs may reduce national control over domestic climate change policies, the WB proposal aims to respect *countries' sovereignty* (allowing each jurisdiction to choose the appropriate level of trading in which to engage) → race to the top?

The World Bank proposal: cons

- A misevaluation by rating agencies may have serious consequences, possibly causing a ‘domino effect’ that may end up damaging the stability and *credibility* of the whole system.
- Fluctuations in the carbon exchange rates might hamper the stability of carbon markets, increasing the role of expectations and speculative attacks which could lead to *enhanced price volatility* (vs. “improved price predictability”, one of the main motivations underlying the WB proposal)

Conclusion

- Linking ETSs is an opportunity to overcome the current stalemate of international climate change negotiations and increase the effectiveness of the existing domestic or regional regimes.
- There are three possible options for linking among ETS at a global or at an international level, which are meant to be read as a *continuum*...
- Beyond linking, the World Bank proposal for 'networking carbon markets' deserves attention. However, it should be taken with caution, as it could generate a <u>financialization of carbon markets</u> that might set them apart from the environmental target it should help to reach.