

# **Towards a Global Carbon Market?**

## **Legal and Design-based Challenges of Linking Different Entity Level Emissions Trading Schemes**

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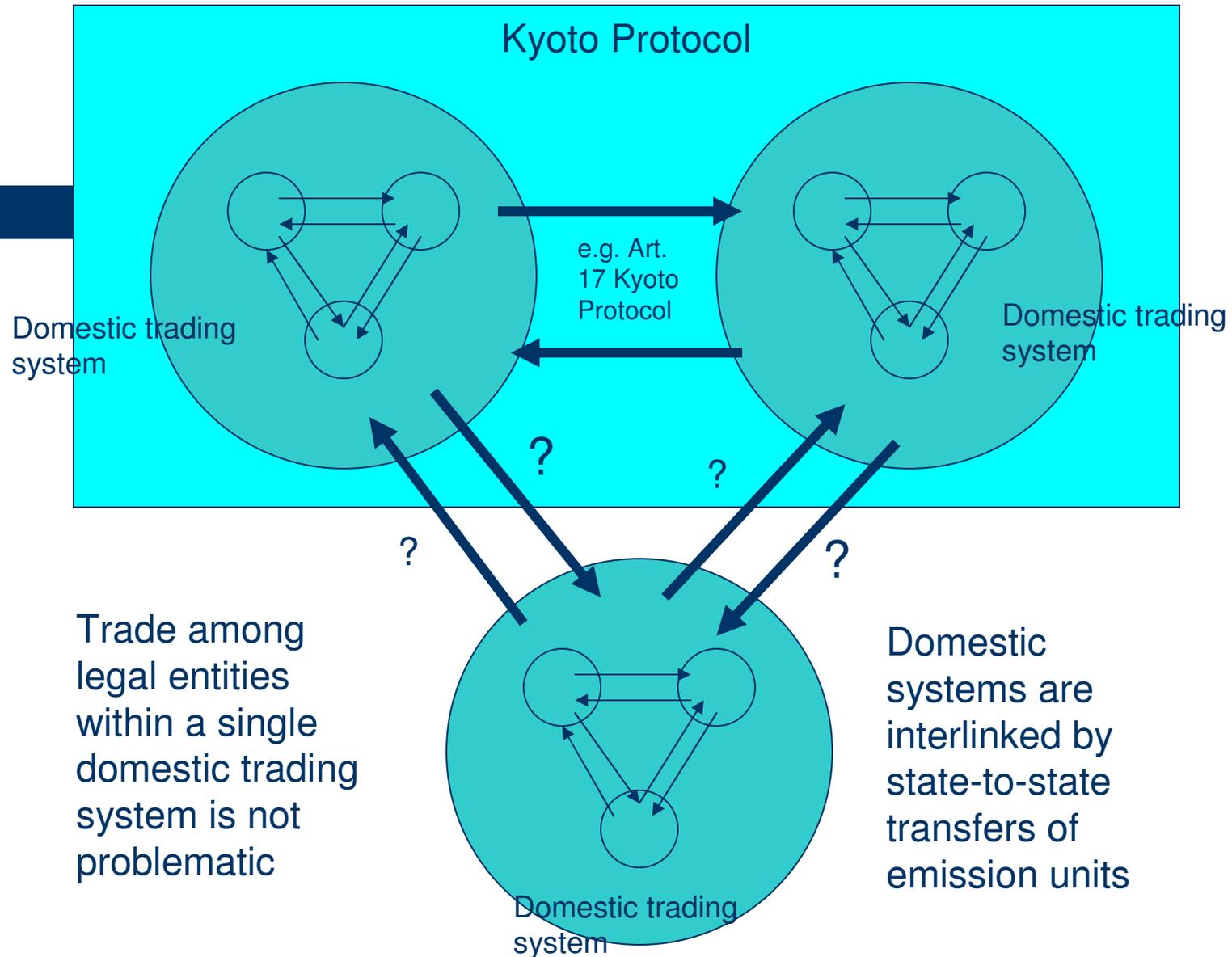
# Focus of the presentation

- Type of policy instrument examined: Emissions trading and credit schemes on the entity level, not implying that they can remain the only approach to GHG emissions reductions
- Examination of major design choices relevant for linking different types of schemes
- Explanation of major legal pitfalls to linking
- No focus on technical aspects (monitoring, reporting, registry systems)
  
- Most developed schemes to date: EU ETS (operating), RGGI (starting 2009), CCX (operating)
- Further approaches: NSW GGAS, Norwegian scheme, Canadian proposal from 2005

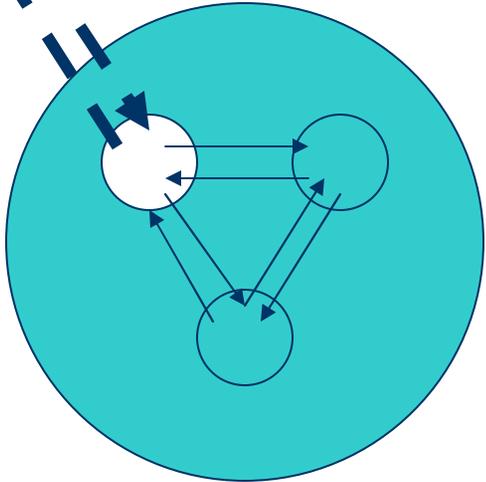
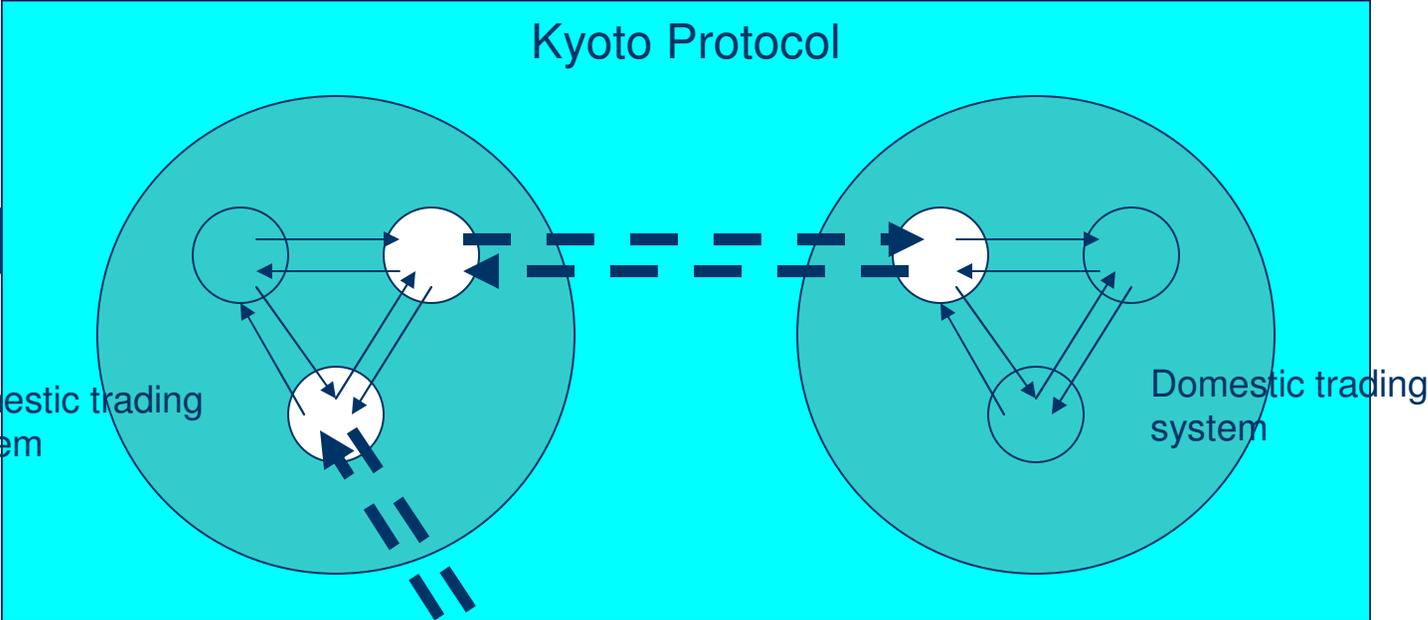
# Overview of presentation

1. Recalling the basic economics of emissions trading
2. The linking challenge – research questions
3. Scheme design issues critical for linking and how to address them
4. Legal Problems of linking and potential solutions to them
5. Proposals for a more open international Climate Regime after 2012

# Transfer of emissions rights between different trading schemes



# Emissions Trading on the entity level



Can legal entities trade directly between different systems?

# The economics of emissions trading in a globalized world (I)

- Emissions trading as an instrument to internalize externalities (Dales)
- For a price of emissions certificates to form, scarcity must be created and maintained
- Problem: The degree of certificate scarcity is artificial and subject to political choice
- Scarcity of emissions rights can mean additional cost/competitive disadvantage for states and legal entities – gaming for higher caps is a rather attractive option for states/legal entities

# The economics of emissions trading in a globalized world (II)

- Proposed remedy: Global emissions trading system
  - CO2 reductions becomes possible at the lowest possible cost for the world economy
  - A global approach has not been reached yet, Kyoto Protocol might serve as a framework, but excludes major emitters like the US and is blind to efforts of sub-national entities like cities and of non-Annex-I parties
- ▶ The linking of regional and domestic schemes seems as the solution coming closest to a global market at the moment

# Main questions to be answered

- ▶ First question: Assuming that linking up schemes is economically efficient – what is its effect on GHG mitigation? – design question
- ▶ Second question: Assuming design problems do not exist or can be resolved – what are the main legal challenges to linking and how could they be addressed?

# The relationship of legal issues and design issues in linking

- Legal conditions:
  - mostly predefined by international and domestic law
  - difficult to change, especially with respect to international law
- Design choices:
  - Can currently be made by domestic/regional regulators independently from international law and the choices of other regulators
- Both challenges can appear in combination or alone depending on the linking scenario

# Most important design choices (I)

## Scheme coverage/Unit definition and recognition

- Scheme coverage
  - Which emitters are to be included (upstream/downstream?) – What is the geographical coverage? What gases are to be included?
    - So far strong preference of regulators for downstream schemes covering large direct emitters (EU ETS, RGGI, CCX)
- Trading and sustainable development – what is tradable?
  - What do the reductions represented by certificates mean for long-term development?
  - Are certificates setting perverse incentives?
  - Linking can potentially undermine standard-setting with respect to units if a scheme with higher standards links up with a low-standard scheme
- EU, RGGI and CCX have a preference for requiring certain standards for offsets
- CCX as a private and voluntary system can cause problems in this respect (free-riding / double counting)

# Most important design choices (II)

## Target-setting and allocation

- Massive problems arise with respect to rate-based schemes (e.g. the Canadian proposal) – environmental integrity cannot be assured
- Cap-and-trade model is to be preferred (e.g. chosen by EU, RGGI and CCX)
- Main problem here: political determination of the relevant caps, over-allocation can occur (EU example)
- Potential remedy: auctioning of allowances, but reliable and verifiable baselines must be in place as a minimum condition of linking

## Most important design choices (III)

### Compliance and penalty rules

- Penalty levels for non-complying entities should ideally be harmonized between schemes that are linking up
- Emitters should not be allowed to buy themselves out of compliance -> otherwise “compliance shifting” will occur between schemes
- Price caps are to be avoided, at least have to be set very high
- All credits available for compliance must be connected to real reductions

# So design matters...

- There are design issues that have to be resolved if linking is to be environmentally successful
- The EU ETS, RGGI and the CCX - the three most developed schemes to date - do not have many critical design differences
- Certain reservations are necessary with respect to private schemes (voluntariness / risk of free-riding and double counting)

## ...and so does law

- Especially the EU ETS and RGGI seem rather compatible in terms of design
- Consequently the legal background to a linking scenario deserves attention

# Major legal challenges to linking between existing Emissions Trading Schemes (I)

## The international level

- Different international commitments of regulators
  - Kyoto regulators will tend to keep an eye on Kyoto compliance (example: RGGI can import EU ETS certificates, EU will most likely have no interest to import RGGI certificates)
  - Kyoto as an agreement of states not open to sub-domestic regulators
  - Difficulties for willing non-Annex-I states to “sign in” to the Kyoto architecture
- Proposed remedy:
  - Creation of a more open international architecture that allows capped schemes or sectors to “sign in” and participate in trading after preliminary control

## Major legal challenges to linking between existing Emissions Trading Schemes (II)

### The domestic level

- Constitutional issues:
  - Sub-domestic entities are often legally incapable to conclude binding agreements on the international level (e.g. American Constitution)
- Proposed remedy:
  - a more open international architecture allowing for non-binding agreements with respect to sub-national/private trading schemes

# Proposal for a more open international architecture

- To be considered in case of failure of negotiation to a Kyoto successor agreement
- “Coalition of the willing” – state parties concluding framework agreement to limit GHGs, other parties are allowed to “sign in”
  - Example given by RGGI – based on non-binding Memorandum of Understanding
  - Approval process could be inspired by project-based mechanisms, especially the CDM in terms of standard-setting and institutions
  - Unresolved Problem: Relationship between emissions trading / non-trading sector
  - Even if linked up, the existing emissions trading schemes would hardly make a meaningful contribution to combating climate change



**Thank you!**

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