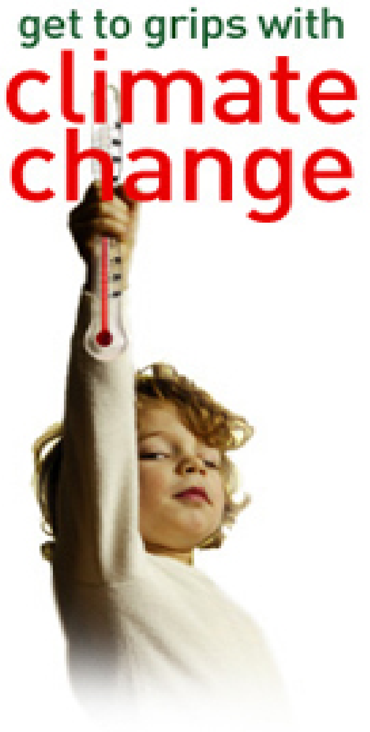

Linking the EU ETS

Opportunities and challenges

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Potential benefits

- Expands market & increases cost-effective functioning by increasing market liquidity and diversity in marginal abatement costs − more access to low cost emissions reductions.
- Strengthens cooperation between parties with binding targets and increases incentives for others to take such targets on board
- Developing a global carbon market - putting a price on carbon stimulates investment in cleaner technologies
- Links to JI/CDM enhance technology transfer to countries and involves sectors not covered by EU ETS in reduction efforts

Potential Risks

- Poorly-designed linked ETS can undermine whole environmental effectiveness of (e.g. price caps)
- By-passing environmental guarantees (e.g. negative list JI/CDM projects)
- Impact competition between companies (e.g. unequal target or allocation rules)
- Overly-complicated “gateways” increase transaction costs

➢ **Success depends on compatibility of schemes and management of incompatibilities**

Legal basis for linking the EU ETS

- Art 25(1): agreements should be concluded with third countries listed in Annex B to the Kyoto Protocol which have ratified the Protocol to provide for the mutual recognition of allowances between the Community scheme and other greenhouse gas emissions trading schemes in accordance with the rules set out in Article 300 of the Treaty.

- Where an agreement referred to in paragraph 1 has been concluded, the Commission shall draw up any necessary provisions relating to the mutual recognition of allowances under that agreement in accordance with the comitology procedure referred to in Article 23(2) of ETS Directive.

Linking with ETS in Kyoto Parties

- Initially 38 countries listed in Annex B to Kyoto Protocol
  - 25 already part of EU ETS (+ Cyprus and Malta)
  - Croatia preparing for participation
  - Norway, Iceland and Liechtenstein - EEA agreement
  - Linking agreements possible with New Zealand, Canada, Japan, Switzerland, Russia, Ukraine, Monaco

Linking with schemes in non-Kyoto countries

Recital 18 of the Linking Directive:

Commission should examine whether it could be possible to conclude agreements with countries listed in Annex B to the Kyoto Protocol which have yet to ratify it, to provide for the recognition of allowances between the Community scheme and mandatory GHG ETS capping absolute emissions established within those countries

Possible candidates

- US Regional Greenhouse Gas Initiative
- California ETS and Western Greenhouse Gas Initiative
- Australian States and Territories
- Possible national schemes in Australia and US

Issues for linking agreements

Of more importance

- Currency used and its status (AAUs, EUAs, ERUs, CERs, RMUs)
- Quality of monitoring and reporting provisions
- Communication between registries (Kyoto Protocol standards)
- Level and types of sanctions
- Type of target/cap (absolute/relative - voluntary/binding) and stringency
- Extent of governmental intervention (caps/ safety valves/ex-post adjustments)
- Direct vs. indirect approach / Upstream vs. downstream
- Banking and borrowing

Of lesser importance

- Sector and gas coverage
- Trading periods
- Allocation method

➢ **If insufficient overlaps can be found, need a "gateway" regulating trade between systems (quantitative and/or qualitative restrictions)**

Lessons to be learnt from EU ETS

- Keep overall objective in mind - tackling global climate change
  - Emissions trading schemes should link up for maximum global effectiveness
  - Consideration should be given to ensure compatibility of systems
  - Significant reductions in emissions are needed through mandatory legislative action
  - Focus: on direct, absolute emissions from across economy

- Keep emissions trading simple
  - Keep transaction costs low (simple allocation, no ex-post adjustments)
  - Let market develop without interference (no safety valves/ price caps)
  - Use private sector for verification

- No need to re-invent the wheel
  - Use of robust data as basis for (any free) allocation
  - EU's monitoring and reporting guidelines
  - Sound electronic registry software in place for emissions trading
  - EU ETS review and other proposals: evolving design experience

State of play

- EC is in dialogue with key partners
- Finalising the extension of the Directive to Norway, Iceland, Lichtenstein
- Examine the organisational and technical issues associated with linking to other schemes under Article 25 of Directive
- In EU ETS review examine conditions for linking to non-Kyoto countries
  - C*rucial design elements, compatibility* of existing and planned schemes
  - *Negotiate legal framework* to put in place to establish links
  - Stakeholder consultation through ECCP workgroup on ETS review

Conclusions

- Main objective: reduce greenhouse gas emissions- to do so at least cost
- Linking interesting for political, economic and environmental reasons
- But need compatible design features and agree how to manage common system
- Gateways may be needed to guarantee environmental integrity
- Because of its size EU ETS is interesting to link into both for buyers and for sellers
- EU first mover advantage implies that other systems will have to adapt to EU system if they want to link up
- EU gained lots of experience on what harmonised components are desirable for a functioning system

More info on EU climate policy: http://europa.eu.int/comm/environment/climat/home_en.htm

Background literature on EU ETS: http://www.claeys-casteels.com

Linking agreement

Questions on approach to an agreement

- How prescriptive should provisions be and what role for member/governing bodies to change provisions
- How to change provisions (voting rules, weights etc.)
- Frequency of meetings, aim of meetings
- Rules for expansion of membership
- Legal provisions for withdrawal of membership
- Links to international trade law

➢ European Commission preparing astudy on structure and content of agreements for mutual recognition in preparation