

Feature

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KEY POINTS

- California, Australia and the EU have advocated the principle of linking for some time.
- However, the hard reality is that trying to link schemes with very different characteristics could prove problematic, particularly in the context of schemes which are intended to be guided by market supply and demand.
- Creating a framework that allows adequate account to be taken of political and economic interests in different jurisdictions in response to an urgent regulatory problem seems challenging.

Linking international carbon markets?

WHAT IS AN EMISSIONS TRADING SCHEME?

Broadly speaking, under an emissions trading scheme, a cap is placed on the total amount of emissions that compliance entities can emit during a specified period. Allowances are issued (either for free or by auction) to compliance entities up to the level of the cap. Compliance entities must surrender an allowance, or unit for each tonne of carbon dioxide they emit, at the end of a compliance year. Entities with spare allowances can sell them to entities that are short of allowances directly or via trading entities including brokers and exchanges. Typically, additional emissions reductions can be brought into schemes (up to certain limits) from emission reduction projects outside of the scheme (such as from developing countries) which can be surrendered in the same way as allowances.

WHAT IS LINKING AND WHAT EFFECT WOULD IT HAVE ON THE BANKING SECTOR?

The idea of linking is that allowances representing tonnes of Greenhouse Gas equivalent used in one scheme (EU Allowances or EUAs in the case of the EU ETS), can be “surrendered” to satisfy compliance obligations of emitters in another scheme.

Linking increases liquidity in the emissions market and broadens the range of opportunities for cost-effective emissions abatement. For example, if a power station in the EU did not have enough allowances to surrender in respect of its emissions, it could purchase allowances not just from other entities in the EU, but from a linked scheme such as the ACPM. Entities trading carbon, often banks and financial institutions would have access to far more liquid markets both in terms of compliance assets, for example in allowances and also in offset credits like certified emission reductions (CERs).

In a linked world, entities are also more likely to be able to develop financial

Market-based responses to fighting pollution, particularly greenhouse gas pollution, were once very much in vogue. The European Union’s target of an OECD-wide carbon market by 2015 appeared optimistic but not wholly untenable, with cap and trade proposals on the table in countries as geographically disbursed as the US, Japan and Australia. More recently, the EU seems to have been ploughing a lonely furrow with the EU Emissions Trading Scheme (ETS).

The introduction of the Australian Carbon Pricing Mechanism (ACPM) and California’s Assembly Bill 32 (AB32) gave new optimism to supporters of emissions trading schemes. But do they provide the platform for increasing global emissions trading unity, or are the Australian, Californian and EU approaches likely to bump along in lonely isolation?

products in this area that appeal across a range of jurisdictions rather than in isolated markets, generating critical mass and spreading risk.

HOW DO THE SCHEMES COMPARE? Compliance entities

“Liable entities” under the ACPM will in general be those that exceed a threshold of 25,000 tonnes of “covered carbon dioxide equivalent” per facility. The ACPM will apply to stationary energy, industrial processes, fugitive emissions (except from decommissioned coal mines) and emissions from non-legacy waste. As with the EU ETS¹, agriculture and land sector emissions are excluded from the ACPM. Transport fuel for households and light commercial vehicles and fuel used by agriculture, forestry and fisheries are also excluded. Other business transport emissions from liquid fuels (rail and shipping) and non-transport emissions from businesses using liquid fuels will be subject to an equivalent carbon price, generally applied by reducing business fuel tax credits by an amount equivalent to placing carbon price on liquid fuel emissions.

Installations under the EU ETS include a broad range of activities, subject to specified thresholds being reached. These sectors and activities include certain combustion installations, oil refineries, production of various metals, pulp/paper, carbon black

and certain chemicals. Carbon capture and storage facilities are also subject to the EU ETS. Emissions from aircraft operators for flights into and out of the EU are covered from 2012.

In California, industrial sources and electric generating units over 25,000 tonnes CO₂e will be covered by the first phase (2013–2014). The second phase, beginning in 2015, will include transportation and heating fuels.

Phases

The ACPM provides for a “Fixed Price” phase from 1 July 2012 to 30 June 2015. A “Flexible Price” phase will apply from 1 July 2015 onwards (with a price collar in place for the first three years of the flexible price phase). Phase II of the EU ETS runs from 1 January 2008 to 31 December 2012; phase III runs from 1 January 2013 to 31 December 2020. There will be no fixed price mechanism or price collar.

The California market rules provide for three phases of stepped reduction; the first phase runs from 2013–2014; the second spans 2015–2017; the third runs from 2018–2020. The California system does not contain a pricing mechanism per se, but does stipulate an allowance price auction floor of \$10 per tonne (adjusted upward annually at 5% plus an inflation index) and provides for a rather complex cost containment reserve that serves a quasi-quantitative easing

function should allowance prices reach certain trigger levels.

Caps

The Australian government will announce the caps for the first five years of the Flexible Price phase in the 2014 Budget and will be required to table regulations setting five years of pollution caps in the Parliament by 31 May 2014. The cap will be extended by one year every year from 2015–2016 to maintain five years of known caps at any given time.

Under the EU ETS, the cap has been determined to be 2,039,152,882 EUAs in 2013. This will decrease each year by 1.74% of the average annual total quantity of allowances issued by member states in 2008–2012. This annual reduction will continue beyond 2020 but may be subject to revision not later than 2025. Aviation has a separate cap.

Under AB32, the first phase sets a cap at 162.8 and 159.7 million tonnes annually for 2013–2014 respectively. The cap increases to 394.5 tonnes in 2015 (which actually represents an additional reduction from projected emissions adjusting for the expanded pool of covered facilities to include fuel producers starting in 2015), falling during the second (2015–2017) and third (2018–2020) compliance periods by approximately 12 million tonnes (about 3%) per year, a cumulative reduction of 70 million tonnes over the span of the eight-year market.

Allocation

Under the ACPM, free allocation of carbon units will be based on historical industry average levels of emissions per unit of production. During the Fixed Price phase, there will be no auctioning carbon units, but there will be some advance auctioning of flexible period carbon units during this period. During the Flexible Price phase, permits will be allocated by auctioning, taking into account transitional assistance provisions for key sectors.

Under the EU ETS, free allocation will be 80% of total EU emissions from 2005–2007 that a particular installation emitted.

The quantity of EUAs allocated freely will decrease in each subsequent year, to 30% free allocation by 2020. 100% of emissions in the power sector will be auctioned in phase III. Sectors identified as being of significant risk of carbon leakage will receive 100% of their emission allocation for free. In phase III, benchmarks for free allocation have been set based on the average performance of the 10% most efficient installations in a sector or subsector in the EU in the years 2007–2008. It is expected that roughly half of the allowances under the EU ETS will be auctioned. 120 million allowances for phase III will be auctioned in 2012, the year before phase III starts. In addition, in the aviation sector, 15% of the EU Aviation Allowances (EUAs) will be auctioned from 2012.

Under AB32, “free” allowances will be distributed to most covered industrial categories based either on a product output basis or energy input basis, depending on the sector. Initial allocations will be approximately 90% of projected needs, phasing toward an auction format over time at different rates depending on the particular industrial sector’s designated exposure to leakage. Allocations are intended to be based on sector averages, and thus reward more efficient individual facilities. Allowances for electric utilities will be handled somewhat differently; allowances will be given to covered entities but must be auctioned for the benefit of revenue recycling to electricity consumers.

Pricing

The price of an EUA is set by supply and demand in the market. The table summarises the approach under the ACPM.

Though AB32 does not contain a pricing mechanism *per se*, it does stipulate an allowance price auction floor of \$10 per tonne (adjusted for inflation plus 5% annually) and also provides for a rather complex cost containment reserve that serves a quasi-quantitative easing function should allowance prices reach certain trigger levels in the range of US\$40–50 per tonne.

APPROACH UNDER THE ACPM

Fixed Price phase (1 July 2012–30 June 2015)

2012–2013	\$23
2013–2014	\$24.15
2014–2015	\$25.40

Flexible Price phase (1 July 2015 onwards)

A price ceiling will operate for the first three years of the Flexible Price phase. It will be set at \$20 above the expected international price for 2015–2016 and will rise by 5% p.a. in real terms each year.

A price floor will operate for the first three years of the flexible price period. This will start at \$15 and rise by 4% in real terms each year.

Banking and borrowing

Under the ACPM’s Fixed Price phase, carbon units bought for the fixed price phase will be automatically surrendered and are not bankable or tradable. Under the flexible price phase, carbon units are bankable for future use. Liable entities can borrow up to 5% of the carbon units they are obliged to surrender from the following vintage year.

Under phase III of the EU ETS, there is no limit on banking of EUAs. Entities entitled to any free allocations will receive them more than a year in advance of the surrendering deadline for a year’s emissions and can use them for compliance for the current year’s emissions. AB32 provides for relatively open trading of allowances and offsets. Participants (covered entities, marketers, traders, verifiers, offset project developers) must register with a California authority and third-party registries will serialise and track compliance instruments. There are certain purchase limits and position limits. Banking is freely allowed but there is no provision for borrowing. The 8% offset limit, however, cannot be transferred or banked across compliance years.

Penalties

Under the ACPM, for a shortfall in a given compliance year, the penalty would be

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USE OF OFFSETS UNDER THE ACPM AND EU ETS

	ACPM	EU ETS
USE OF KYOTO UNITS (TO MEET LIABILITIES)	<p>Not permitted in the Fixed Price phase</p> <p>In the flexible price period, until 2020, liable entities may submit Kyoto Units to fulfil up to 50% of their annual compliance obligations.</p> <p>This quantitative restriction will be reviewed by the Climate Change Authority in 2016.</p>	<p>For Phase II, member states allowed their operators to use significant quantities of Clean Development Mechanism (CDM) and JI (Joint Implementation) project credits</p> <p>The right to use these credits has been extended into phase III. A limited additional quantity can be used in such a way that the overall use of credits is limited to 50% of the EU-wide emission reductions over the period 2008–2020.</p> <p>Existing operators will be able to use credits up to a minimum of 11% of their allocation during the period 2008–2012, while a top-up is foreseen for some operators.</p> <p>New sectors and new entrants in the third trading period will have a guaranteed minimum access to offsets of 4.5% of their verified emissions during the period 2013–2020. For the aviation sector, the minimum access will be 1.5%</p> <p>The precise percentages will be determined through comitology.</p>
ELIGIBLE INTERNATIONAL EMISSIONS UNITS	<p>All Certified Emission Reductions (CERs) and ERUs (Emission Reduction Units) except those from: nuclear projects, the destruction of HFC-23 (trifluoromethane), nitric oxide (N₂O) from adipic acid plants or large-scale hydro projects that are not consistent with EU compliance criteria based on WCD (the World Commission on Dams).</p> <p>Long-term and temporary CERs will not be eligible.</p> <p>Any other international units that the government may allow by regulation.</p>	<p>From phase III, All CERs except those from afforestation, reforestation and nuclear projects or those from projects which destroy the two industrial gases HFC-23 and adipic acid N₂O.</p> <p>Special rules apply to the approval of large-scale hydro projects.</p> <p>From Phase III, only credits from new CDM projects registered in Lest Developed Countries will be allowed.</p>

1.3 times the fixed price cost of a carbon unit during the Fixed Price phase. Under the flexible price phase the penalty would be double the average price of carbon units for that year. In the EU, a penalty of €100 is paid for each tonne of carbon dioxide equivalent emitted for which the Operator has not surrendered allowances, and the operator must in any event make up for the unsurrendered allowances. Under AB32, the penalty for non-compliance is essentially a quadruple penalty; that is, violators will pay a treble penalty based on excess emissions, while covering the deficiency of allowances. Violations of the market rules can also be subject to civil penalties under California's environmental code.

Use of offsets

The position in relation to the use of offsets under the ACPM and EU ETS is summarised in the table (above).

In addition, under the ACPM, Australian carbon credit units issued under the Carbon Farming Initiative can be used for compliance, as can RMUs (removal units) issued by a Kyoto Protocol country on the basis of land-use, land-use change and forestry activities under Art 3.3 or 3.4 of the Kyoto Protocol.

The Australian government reserves the right to place restrictions on the use of international units in future or to disallow the use of any international unit, at any time to ensure the environmental integrity of the ACPM and consistency with Australia's

international obligations. The EU may choose to impose further restrictions on the use of specific credits from project types from 1 January 2013.

It is noteworthy that, under the AB32 market rules there is a greater emphasis on promoting additional emissions reductions from non-covered sources in California, as opposed to funding reductions in developing countries, and to some extent on reductions in other US states.

California will recognise the use of approved offsets from official compliance protocols (ie, project types) up to 8% of a covered entity's compliance obligation. The offset quota cannot be transferred or banked to a subsequent compliance year. A significant issue that has arisen is the possibility that

offset credits, once issued, can be revoked or invalidated retrospectively by the California agency, thus creating potential buyer liability risk. California has announced the intention to adopt an additional set of protocols for natural gas transmission systems, rice cultivation and fertiliser application, and others are being discussed as well.

The market rules also authorise California to develop sector-based offsets, including international linkages to sector based programmes in developing countries or subnational jurisdictions, although use of such offset credits is further restricted to one quarter (and one half after 2017) of a facility's compliance obligation. Eligibility of sector-based credits will require further administrative rulemaking from the Californian authorities.

To date, California has approved four compliance protocols as eligible to generate offsets under the California system (ODS destruction, agricultural methane capture, forestry and urban forestry). Each of these protocols recognised projects developed anywhere in the US, but the project categories themselves were, significantly, chosen over other candidates based on their ability to be developed in California and thus generate "in state" emissions reductions. California has also been in discussions with various developing countries, chiefly Brazil and Indonesia to lay a path forward to crediting Reducing Emissions for Deforestation and Forest Degradation (REDD) for use in California's carbon market using a "sectoral" approach. Indeed, California's newly adopted market rules contemplate that REDD credits would be available sometime during the second phase of the programme covering 2015–2017; however, at this time California's thinking with regard to linking is still in an elementary stage and there is some scepticism whether a format can be designed that would support the level of integrity that environmental stakeholders in California would demand.

WHAT IS IMPORTANT TO LINK EMISSIONS TRADING SCHEMES?

There are fundamental issues that will need to be addressed before the schemes can link,

beginning with an assessment of the overall stringency of each scheme and to what extent the effort required by entities regulated under the schemes is comparable. Regulators will need to analyse whether schemes to which a link is considered are sufficiently robust in terms of their environmental integrity. If they are not, it may be that an "exchange rate" could be introduced which could mean that multiple allowances or units from one scheme would be deemed to be equivalent to only one allowance or unit from a scheme to which it was linked.

Another key issue is that of legal sanctions for breach of the regime. The EU, Australia and California are likely to be able to trust that each jurisdiction will properly enforce their individual schemes. More significantly, regulators will need to trust each other to adequately guide schemes through the inevitable turbulence of the carbon markets. Faced with uncertainties about the ongoing international negotiations, the legal nature of domestic targets going forward and the offset pipeline, schemes must be robustly managed to ensure that they respond to surrounding policy uncertainty and attract investor confidence. Issues such as registry security and fraud which have dogged the EU ETS are likely to continue and so each jurisdiction will have to ensure that it trusts the other to properly respond to such challenges. It may be difficult for the schemes to interact if there are greater levels of policy uncertainty and risk on one side.

The approach to pricing allowances within schemes will also be important. The ACPM has a fixed price phase built into the first three years of the scheme, and thereafter a collar will apply for a further three years. AB32 provides for an auction price floor. The EU has not sought to impose floors and collars, leaving pricing to the market. Linking the EU to a scheme with price management mechanisms could therefore create the kind of price distortions that would render linking impossible, potentially ruling out any link between the EU ETS and the ACPM until 2018.

Another fundamental design characteristic is the extent to which schemes

allow cost containment through the use of "offsets" (being credits imported into the scheme from emissions reduction projects outside of the relevant cap). This issue relates both to the nature and type of offsets permitted for use and also to the extent to which they can be used. Australia appears broadly to have mirrored the EU's offset criteria, easing any potential linking.

It will be interesting to see whether Australia eventually follows the EU in implementing requirements in respect of the use of the CERs coming only from Least Developed Countries for Clean Development Mechanism (CDM) projects registered from 2013. Unless the current provisions are changed, Australia risks becoming a "dumping ground" for CDM projects registered after 2012 whose credits are not eligible under the EU ETS. The implications of this would need to be assessed in terms of linking these schemes. Another residual concern is the Australian government's intentions with regard to the use of RMUs, which are not allowed in the EU. European regulators would need to assess the implications of Australia's divergent approach.

While an economic assessment of the ability to use offsets is yet to be carried out under the two schemes, from a legislative point of view, the EU has tried hard to clamp down on offset use for Phase III and may look to Australia to do the same in order for a sufficiently stringent linked scheme to be implemented. California has adopted a very different approach to the EU and Australia with respect to offsets. In particular, the EU has all but ruled out the use of REDD credits for the significant future.

In addition to the fundamental issues listed above, a number of more "technical" issues are likely to need to be resolved. For example, linked schemes must have robust systems of monitoring, reporting and verification of emissions. It does not seem necessary for such mechanisms to be similar in order for linking to take place, provided that the MRV (Measurement, Reporting and Verification) systems are sufficiently robust and understood.

For schemes to link there will also need to be a certain degree of connectivity between

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different registries. Registries rules and practices may differ between jurisdictions but would not necessarily need to be fully harmonised for two systems to link, although the EU's system of registries is becoming ever more complicated.

With respect to allocation methodologies, overall stringency is likely to be more of an issue than how carbon assets are actually distributed. An exception might be where one jurisdiction favours an allocation methodology which has a substantial impact on price in another jurisdiction. This could occur, for example, where significant volumes of assets are auctioned and released into the market, requiring co-ordination between schemes.

The key to resolving many of these technical issues seems to lie in harmonising administration and regulatory practices. While it is likely that differently shaped regimes can co-exist, it will be difficult for them to continue to rub along in harmony unless there is ongoing dialogue between regulators about issues confronting the market, "surprise" events that cause uncertainty (such as issues around stolen carbon assets or VAT fraud) and price crashes/spikes. Creating a framework that

allows adequate account to be taken of political and economic interests in different jurisdictions in response to an urgent regulatory problem seems challenging.

IS A LINK POSSIBLE?

At first glance, it would appear that a number of ducks have already been lined up at a policy level in support of a potential link between the EU and Australia. In Australia, it has been indicated that linking to other credible trading schemes, including the EU ETS and the New Zealand ETS, is in Australia's national interest, provided that they are of a suitable standard.

California has stated that its cap-and-trade system has been "designed so that California may link up with programmes in other states or provinces within the Western Climate Initiative, including British Columbia, Ontario and Quebec", however it is far less apparent how California will navigate the actual mechanics and politics of achieving this asserted goal. Agency staff have stated that they are preparing linking rules to be considered by the California administrative agency in 2012.

The EU has also advocated the principle of linking for some time. However, the hard

reality is that trying to link two schemes with very different characteristics could prove problematic, particularly in the context of schemes which are intended to be guided by market supply and demand (and are therefore subject to market uncertainties in different jurisdictions). Different political priorities would need to be addressed. For example, the EU would not be successful in achieving its policy goals if a linked market resulted in all emissions abatement taking place in Australia, and EU installations relied wholly on relatively inexpensive Australian carbon to meet their compliance obligations, rather than investing in emissions abatement technology. Equally, it would be politically unpalatable if linking with the EU ETS resulted in increasing the cost of carbon in Australia.

Finally, though both the EU and Australian schemes contemplate the possibility of linking, under the ACPM, export of Australian carbon units will not be permitted in the "Fixed Price phase" or under the "Floating Price phase" while a domestic price ceiling is in place, appearing to rule out linking until 2018 at the earliest. ■

1 In general, we have focussed on the EU ETS as it will apply from 2013.