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Linking EU – Canada Emission Trading Systems An Opinion Paper By IETA

MARKET SOLUTIONS FOR GLOBAL ENVIRONMENTAL PROBLEMS

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1.0 Introduction

The Kyoto Protocol provides the foundation necessary for ensuring international emissions trading. In order to reduce emissions and help meet their international obligations Annex B nations, are starting to implement domestic emissions trading programs as an instrument to meet their commitments for certain sectors of the economy. The purpose of this paper is to explore the potential for a bilateral agreement between the European Union and Canada to include emissions trading as one of the key discussion points as part of the Canada-EU Trade and Investment Enhancement Agreement (TIEA).

The Kyoto Protocol under article 17 establishes rules for international emissions trading. At the same time under KP there are no set rules on how to link the different domestic trading systems. The EU and Canadian emissions trading systems are at different stages of development. Whereas the EU trading system has been up and running since January 2005, the Canadian system is more in the shape of a proposed system and in an evolutionary stage where it is envisioned some components of the system will be in place by early 2006. Nevertheless it should be a priority for both EU and Canada to initiate the process of linking both their domestic markets to ensure a viable future for a market approach to addressing climate change.

The EU Emissions Trading Systems (ETS) is a cap and trade system, and installations falling under the EU Directive 2003/87/EC have to submit their allocated emissions reductions each year corresponding to their actual emissions. Initial allocations have been made free to the industry or by auctioning. For non-compliance companies have to pay a penalty. The scheme only covers CO₂ for the first period (2005-2007). Member states may voluntarily include other GHG gases as well as other sectors in the second period (2008-2012). In November 2004 the EU adopted the Linking Directive (2004/101/EC) which further clarifies the status of Kyoto project-based mechanism such as the Clean Development Mechanism (CDM) and Joint implementation (JI).

In Canada, at present the government has made public key pieces of its domestic emissions trading regime. The process was initialized by the Government of Canada (GoC) announcement to use Canadian Environmental Protection Act (CEPA 1999) as the main regulatory instrument for ensuring emissions reductions compliance. In recent months the GoC has also published its Notice of Intent to regulate Large Final Emitters (LFEs) in the Canada gazette, as well as it has released its plan for a domestic offsets program titled "Offset System for Greenhouse Gases". All these different responses put forward are a strong signal that the GoC is moving forward at an accelerated pace to establish a domestic emissions trading regime.



After assessing the current developments in the EU and Canada it is important to realize that once IET begins in 2008 it will be crucial for both parties to have bilateral linkages in place to ensure a sustainable emissions trading regime. This paper will focus on a broad perspective provide an insight into why is it desirable to link the EU and Canada emissions trading systems; the possible variables associated with linking the two emission trading systems, the issues that contribute to the concerns, and finally what mechanisms are available for both parties to put in place a bilateral emissions trading regime.

2.0 Benefits of Linking the Two Systems

Linking the EU and Canada emission trading markets is highly desirable for a number of reasons.

- A linkage between the two emission trading regimes will create a market with a larger number of participants, increasing the diversity of control costs and increasing the overall liquidity of the market. This will further contribute to reducing the overall cost of compliance in the two systems while improving the overall economic efficiencies of both emission-trading systems as well.
- Linking of the two programs will provide internationally competing companies in both the EU and Canada a wider regulatory framework with a single price of carbon.
- This will further induce amongst the EU and Canada a need to foster international cooperation on common trade and economic policies, as well as contribute to a multilateral approach on future climate change policies.
- Finally a EU-Canada linkage on emissions trading will not only promote technology transfer and sustainable development, as well by creating a larger global market this should help attract other countries such as US, Australia, India, China, Brazil and South Africa to join in towards the development of the global GHG market.

3.0 Linking EU and Canadian Emissions Trading Programs – The Variables

The EU system is inherently different than the proposed Canadian system. The EU system is a cap and trade program, whereas the Canadian system is an intensity target based system. Linking emissions trading systems with different designs as the EU and Canadian systems should be examined for, environmental integrity, equity and competitiveness, and technical issues.

1. Environmental Integrity

The purpose of emissions trading is to provide a mechanism whereby entities can reduce the compliance cost of achieving a given emissions target. Environmental integrity must be taken into consideration when evaluating a possible linkage between EU and Canada emission trading systems. In this case the fact that an absolute Kyoto Protocol target



exists for both parties will ultimately ensure that environmental integrity will be maintained even if both domestic emissions trading systems were to be linked.

2. Equity and Competitiveness

The EU and Canadian systems are different, whereas one is a classic cap and trade program the other is an intensity / rate based program. A linkage between the two systems will highlight the differences in treatment of similar participants; one with absolute caps the other with intensity targets. These differences, with their equity and competitiveness implications, will exist whether or not the programs are linked, but linking the programs gives them an added significance and visibility.

3. Technical Compatibility

There are issues that need to be addressed such as compatibility of registries, MRV (monitoring reporting & verification), and other issues ensuring that the same commodity is being traded with the ability to be transferred. A primary issue that needs to be taking into consideration when assessing the potential for EU – Canada emissions trading linkage is the issue of “technical compatibility”. By this it is meant that there need be an assessment whether the program administrators in different jurisdictions will accept allowances and credits from other programs to be treated as valid “tender” for meeting the emissions limits of its participants. Any proposed linkages between EU- Canada emissions trading systems should take into consideration the issues surrounding technical compatibility and both parties should address any concerns arising from their respective domestic emissions trading systems before embarking on an international linkage.

4.0 Issues Associated with Linking Emissions Trading Systems

In linking the emissions trading systems a number of issues must be examined and their effect on three dimensions mentioned above is a critical test. The different designs of the EU and Canada domestic systems have an implication on any proposed linkages between the emissions trading regimes of the two parties. A brief discussion is presented below identifying some of the key components in both designs and their associated implications:

Sources Covered: The trading programs can differ in regards to the categories of emitters that are covered under a specific system. Differences in coverage would increase the potential for a higher complementarity due to different controlled costs amongst participants. The difference in coverage would not raise issues of technical compatibility but it may give rise to equity and competitiveness concerns by all sources as well lead to increased emissions from excluded sources.

Emissions Covered: The Kyoto Protocol as designed identifies six greenhouse gas emissions that must be regulated i.e. carbon dioxide, methane, nitrous oxide, hydro fluorocarbons, per fluorocarbons and sulphur hexafluoride. Energy-related CO₂



emissions dominate the total emissions in most countries that have emissions reduction commitments. Differences in coverage do not pose any challenges when linking two emissions trading programs but they may raise concerns about comparable sources in the two regimes receiving a differential treatment. Since both EU and Canada emissions trading systems at present only cover CO₂ emissions with an intention to cover all the greenhouse gases in the future linking both programs should not raise any significant complications in regards to emissions covered.

Stringency of Overall Target: The stringencies of overall emissions may vary across programs for different reasons impacting the compliance costs for participants. The stringency can be measured by various means, including percentage reduction from historic or projected emissions and marginal abatement cost. Linking with domestic emissions systems where marginal abatement cost in one system is higher will increase the price for the combined system and providing the system with a higher abatement cost with an advantage. The concerns would not be in regards to compromising the overall environmental integrity nor regarding technical compatibility but more in regards to equity concerns.

Absolute or Rate-based Allocation: Allocation, whether be it cap, negotiated agreement or baseline that applies to a participant in an emissions trading program may be expressed in absolute terms – total emissions during a specified period, or as an emissions rate – emissions per unit of output, input or activity. A rate-based allocation keeps the economic incentive to increase output, and hence the result is uncertain in terms of the total final emissions. There would be serious environmental integrity concerns in the absence of capped targets, but since both EU and Canada have a capped target the different ways of allocation are not a concern.

Monitoring, Reporting, and Validation (MRV) Requirements: MRV is what measures and defines the commodity, ensuring that both systems are trading in the same commodities. Alternative MRV systems for greenhouse gases with differing levels of accuracy are available. Differences in MRV requirements should not affect the economic efficiency because trading decisions should not be affected by the cost of the monitoring system. Since this is an environmental trading agreement ensuring commodity comparability is essential.

Registry Provisions: The EU and Canadian emissions trading systems both must have their own registry that accurately records the allowances or credits held by their respective market participants. When the two emissions trading systems are linked, it must be possible to move allowances or credits from one registry to another. If both programs choose to share a common approach to the way their respective registries may be structured future transfers of credits will be straightforward. If the EU and Canadian systems adopt differing registry structures credit transfers may still be possible but complications may arise due to incompatibility. This will involve higher administrative costs and possible induce accounting errors.



Penalties: Participants in EU and Canada emissions trading systems are subject to penalties if they do not remit sufficient allowances or credits to cover their actual emissions. Penalties may include a financial penalty, a loss of allowances, or a combination of both. If a penalty is structured so that it is substantially higher than the market price as is the case in both the EU and Canadian systems, it will ensure that the aggregate emissions target is always met even if the compliance cost becomes very large. If penalty is very different between the two emissions trading systems then the environmental integrity may be compromised by the combined system.

5.0 Mechanisms to Provide the Links

A review of the EU and Canada emissions trading systems indicates willingness by both programs to establish links with other trading programs. There are two possible approaches as discussed below that could be used to link the two emissions trading programs.

1. **Negotiated Agreements:** This approach includes a negotiation of an agreement to ensure that any imported allowances or credits are acceptable as substitutes for those of the importing system. The existence of such an agreement means, in principle that proposed transactions will not require individual approval.
2. **Commercial Mechanisms:** The approach relies on proposed commercial mechanism to link different programs. One approach mentioned is a proposed “Carbon Repository” that will receive emissions reductions from a variety of sources and then exchanges them for allowances / credits that can be used for compliance in specified countries at specified dates.

6.0 Conclusion

The paper examines the issues related to linking existing EU and proposed Canadian emissions trading systems for greenhouse gases. The main benefit of linking emissions trading programs is the increased economic efficiency. Linking both emissions trading systems should create a market with a larger number of participants with increased diversity of control costs. This should lower the cost of meeting the overall emissions target of the linked programs.

It is not necessary that the systems be identical in order for linking. Certain features will need to be harmonized to ensure the technical compatibility and environmental integrity of the combined system is ensured. Other differences may result in issues of competitiveness and equity but by themselves will not prevent linking. They represent issues that will need to be addressed in the political and societal arena.