Getting Linked, Breaking Up

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Outline

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Definitions

Unilateral link – One scheme accepts allowances / credits of other scheme for compliance. Other scheme sets **price cap**. May not need cooperation of other scheme.

Bilateral link – Each scheme accepts allowances / credits of the other scheme for compliance. **Prices converge**. Needs agreement of both schemes.

Multilateral link = bilateral link with more than 2 schemes

Linking to a scheme creates an **indirect link** to every scheme with which it is linked

Advantages of Linking

Unilateral link creates a price cap. If price cap is binding, same as a bilateral link.

Bilateral link improves cost-effectiveness of meeting the combined cap and improves market liquidity

Risk is that differences in design could lead to higher aggregate emissions if schemes are linked; schemes need to be "compatible"

Compatibility

Aggregate emissions could increase as a result of linking due to differences in provisions such as:

- allowance lifetime
- non-compliance penalty
- “safety valve” price
- banking
- borrowing
- upstream/downstream treatment of energy
- absolute and relative caps

The greater the similarity of the designs, the easier it is to link the schemes

Compatibility Over Time

Compatibility needs to be maintained as long as schemes are linked. Requires:

- process for agreeing on revisions to the regulations
- mechanism to provide assurance of the environmental effectiveness of each scheme
- procedure for terminating the linking agreement

Each scheme has incentive to make less stringent adjustments to its cap to become a net seller

How to Implement a Link

If registries are not linked electronically, administrator establishes an account in the other scheme's registry to receive units. Issues equivalent allowances in its own registry to entity that provides units. Administrator retires units received. Entity uses or sells allowances received.

If registries are linked electronically, entities can hold other scheme's units in their accounts and transfer them to the administrator for compliance. Units are retired by the administrator.

Linking Experience

EU ETS, Norway ETS, Chicago Climate Exchange (CCX) and Japanese voluntary ETS all have a unilateral link with the CDM, usually with type and quantity restrictions. CERs have not been used in any of those schemes

CCX and Norway had unilateral links with the EU ETS. Both used the link. Norway is now part of EU ETS. CCX terminated its link with Phase I allowances when they fell below the price of CCX allowances

Kyoto Protocol Implications

An Annex B country will want transferred units to be Kyoto units, so:

- Links with schemes outside Annex B countries are unlikely
- Unilateral links with Annex B schemes require the cooperation of the host government to transfer Kyoto units

NZ unilateral link with EU where EUAs are retired, hurts NZ and helps EU with Kyoto compliance. NZ needs to get AAUs, which requires EU cooperation

Proposed Links

Switzerland, New Zealand, Canada, Australia plan unilateral links with the CDM, and sometimes other Kyoto units, with type and/or quantity limits

Canada is interested in links with US schemes. US proposals include links with approved schemes of equivalent stringency constrained by a price trigger or quantity limit

Explicit interest in bilateral links is limited to the EU, New Zealand and Australia

Linking Prospects

More schemes are being implemented. Almost all express interest in unilateral links with CDM. Some interested in bilateral links.

Bilateral links are complicated because they need an agreement to ensure compatibility over time and the agreement is between governments in different countries

No bilateral links before post-2012 agreement has entered into force. Pressure to adjust caps so that CDM is used in each scheme

Breaking Up

Decision, announcement should be handled like any development that affects the market

External units owned at time announcement can be used for compliance or transferred to original scheme

With unilateral link external units probably have higher price and be transferred

With bilateral link, prices will start to diverge so compliance use may be more attractive

Summary

Unilateral links are easy to implement, but need cooperation among Annex B countries

Most schemes will be unilaterally linked with the CDM

Bilateral links are much more complicated to implement and maintain

Breaking up is not so hard

Best short term approach is to adjust caps so that CDM is the marginal supply for all schemes