ICAP

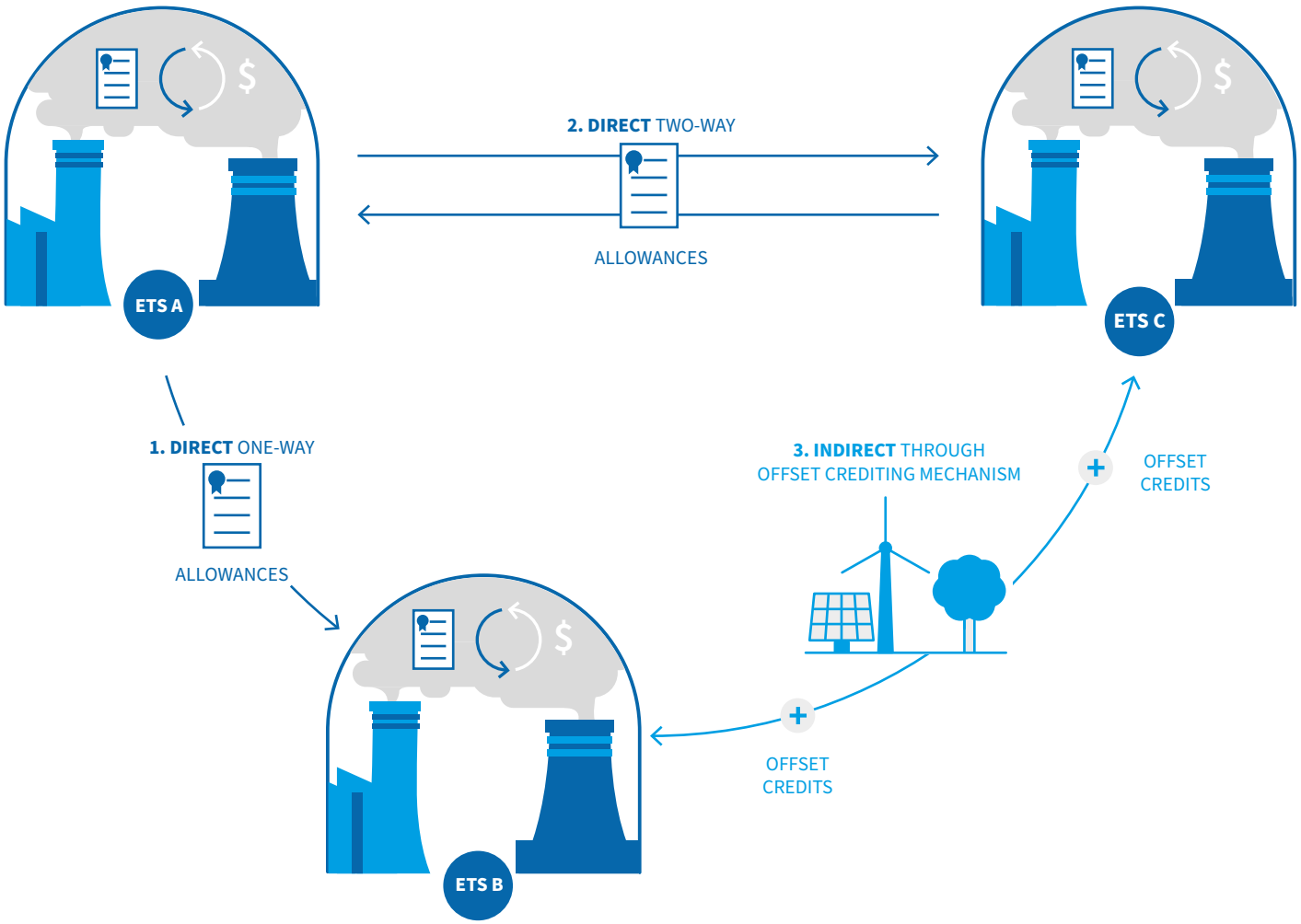
Brief #4

LINKING EMISSIONS TRADING SYSTEMS

An emissions trading system (ETS) is a market-based instrument that can be used to reduce greenhouse gas (GHG) emissions. The government determines a limit (cap) on total emissions in one or more sectors of the economy and issues allowances according to this limit. Companies in these sectors need to hold one allowance for every tonne of emissions they release. They may receive these allowances for free from the government or buy them in auctions organized by the government. Linking ETSs creates a larger carbon market, which can provide the participating jurisdictions with more cost-efficient options to reduce their emissions.

A key advantage of ETSs is that they can be linked together, creating larger, more liquid carbon markets. Linking enables covered entities in an ETS to use allowances from another system for compliance. If fully linked, prices in the different systems will converge, creating one common allowance price.

Linking can take different forms. One-way linking allows covered entities in system A to buy allowances generated in system B. With a two-way link, allowances can flow in both directions across the linked market. Linking can also happen indirectly via other market mechanisms, for example, if both ETSs are linked to the same offset crediting mechanism.



Why link?

ETS linking offers a number of benefits:

1 Linking opens up access to more and potentially cheaper options to reduce emissions. This decreases overall mitigation costs and may allow governments to adopt more ambitious climate targets.

2 Linking reduces competitiveness concerns. It levels the playing field for covered entities across linked markets, as they face the same carbon price.

3 Linking increases the number of market participants and improves market liquidity. With more actors buying and selling allowances, trading is more efficient. A bigger and more liquid carbon market is also better at absorbing shocks, such as sudden changes in commodity prices or exchange rates.

4 Linking can demonstrate climate leadership and encourages international cooperation.

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However, linking is not without its challenges. Governments may need to adjust their ETS design in order to link and be ready to give up some sovereignty in managing the joint market. There may also be concerns that covered entities – by buying allowances from another system – are effectively financing mitigation activities abroad, rather than taking climate action at home.

Linking around the world

In 2014, California and Québec linked their ETSs. In Japan, Tokyo and Saitama Prefecture have been operating a joint carbon market since 2011. The EU ETS is also linked; after the accession of Norway, Iceland, and Liechtenstein to the EU ETS in 2007, the EU ETS linked to the Swiss system in 2020. Last but not least, the Regional Greenhouse Gas Initiative (RGGI) in the northeast of the U.S., initially established in 2009 with ten states, expanded in 2021 to also include Virginia.

2007
Norway, Iceland, Liechteinstein & EU

2009
RGGI

2011
Tokyo & Saitama

2014
Québec & California

2020
Switzerland & EU

ABOUT THE INTERNATIONAL CARBON ACTION PARTNERSHIP: ICAP is an international forum for all levels of governments focusing on best practices in emissions trading. Its work centers on three main pillars: technical dialogue, knowledge sharing, and capacity building. For more information, see the **ICAP website** and its **ETS Map** and **Allowance Price Explorer** or follow us on **Twitter (X) @ICAPSecretariat** and **LinkedIn** (International Carbon Action Partnership).