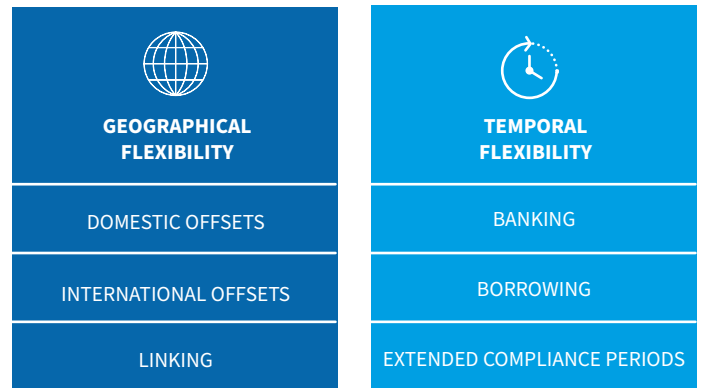


FLEXIBILITY IN EMISSIONS TRADING

An emissions trading system (ETS) is a market-based instrument that can be used to reduce greenhouse gas (GHG) emissions. It works on the principle of ‘cap and trade’. The government imposes a limit (cap) on total emissions in one or more sectors of the economy. Companies in these sectors need to hold one permit for every ton of emissions they release. They may either receive or buy permits, and can trade them with other companies. Besides trading, there are design elements that provide even greater flexibility in ETS.

With an ETS, it does not matter where or when emissions are reduced – as long as they are reduced in line with climate targets. Following this principle, an ETS guarantees that a specific climate target will be reached at the lowest cost to the economy. It is inherently flexible, as companies may choose to reduce emissions themselves or buy permits from others that have done so. Additional flexibility measures give companies even more options: offsets and linking with other systems give regulated entities geographical flexibility (for more on linking, see ICAP ETS Brief #4) while banking and borrowing, and longer compliance periods provide temporal flexibility.



Offsets – reducing emissions outside of the ETS

Offsets are emissions reductions from activities outside the scope of the ETS. There are two main types of offsets – domestic offsets generated within countries, and international offsets. Before offset credits are issued, they must undergo a robust process to ensure the reductions are real and additional – that they would not have happened anyway. Firms can then purchase these credits to meet part of their obligations under the ETS. Typical offset projects include renewable energy, energy efficiency, waste management, agricultural and forestry projects. As offsets come from outside of the ETS, they increase the emissions allowed within the ETS (the cap). Therefore, jurisdictions usually limit the number of offsets that may be used, to ensure that most abatement takes place within the ETS sectors. Furthermore, to maintain the quality of offsets used, they are often limited by type or origin.





OFFSET PROGRAMS AROUND THE WORLD

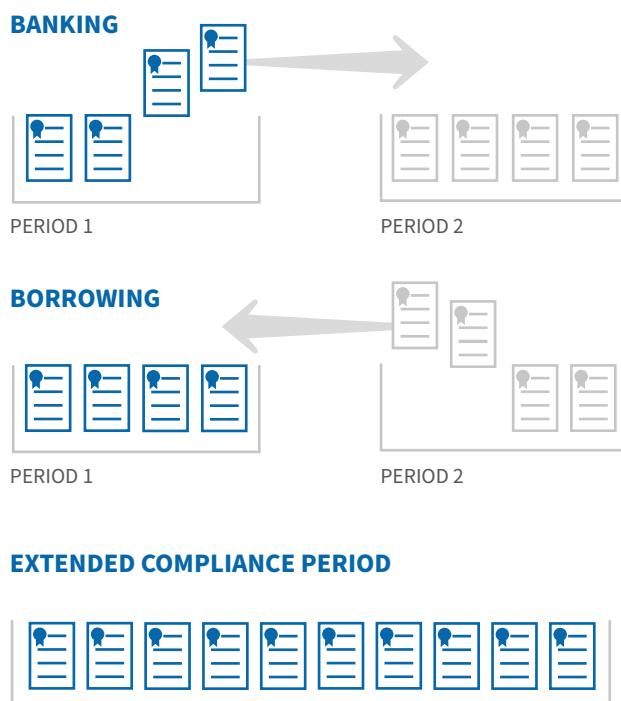
Why use offsets?

Allowing offsets in an ETS provides an additional source of low-cost abatement options for companies. In addition, offsets create benefits outside of the ETS: the possibility to generate and sell offsets creates incentives to reduce emissions in other sectors and regions. Internationally sourced offsets provide financial resources for green development in regions where mitigation funding may be scarce. Furthermore, as offsets make it cheaper to achieve targets they may encourage policy-makers to set a more ambitious cap. However, given concerns about the environmental integrity of some types of offsets like the Clean Development Mechanism (CDM), the trend recently has been towards a more restrictive approach to offsets or a focus on domestic projects rather than international ones.

¹ California and Québec allow offsets mutually sourced from linked jurisdictions
² The Swiss and EU ETS no longer use offsets from 2021
³ New Zealand may readmit international offsets from high integrity sources as early as 2021
⁴ Korea allows domestic credits as well as international CDM credits developed by Korean companies
⁵ Nova Scotia's cap-and-trade legislation includes provisions for an offset program, however as of 2020 an offset program it is not yet operational

Temporal flexibility

Temporal flexibility measures allow entities to manage their emissions in the most cost-effective way over time. With banking, entities can save up permits issued in one period for use in subsequent periods. Borrowing works the other way around. Entities postpone buying permits or reducing emissions (for instance until technology becomes cheaper) by borrowing permits from future periods to use in the current period. Longer compliance periods also give companies flexibility as to when they can buy permits or reduce emissions. All these features help reduce price volatility and smooth out the carbon price over time, as entities can buy permits when they are cheaper – thus causing the price to rise – and sell or borrow permits when prices are high.



Banking and borrowing – setting the right incentives

All existing ETSs allow banking. It may help create private sector groups with a strong interest in ambitious future targets in order to maximize the value of their permits. However, unlimited banking can carry forward the effects of economic shocks such as an oversupply of permits. By contrast, most

jurisdictions limit borrowing or prohibit it completely as it can give companies an incentive to delay reducing emissions, making it harder to reach short-term targets. It may also create groups that would benefit from abandoning climate policy.