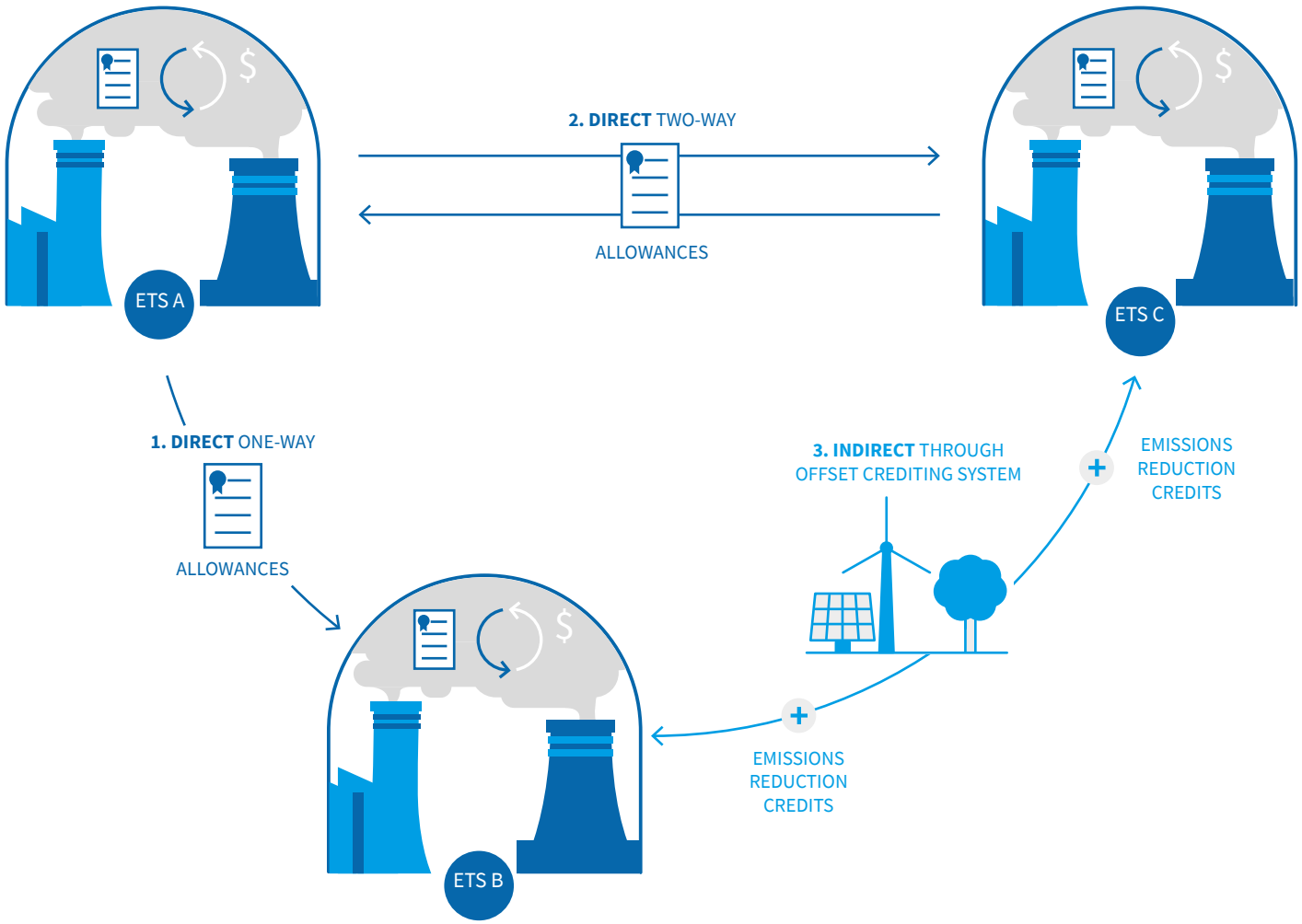
Brief#4

ON THE WAY TO A GLOBAL CARBON MARKET: LINKING EMISSIONS TRADING SYSTEMS

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. This is the 'trade' part of 'cap and trade'.

A key advantage of emissions trading systems (ETSs) is that they can be linked up, creating larger, more liquid carbon markets. Linking enables companies that operate under an ETS to use permits from another system for compliance. Once linked, prices in the different systems will converge, creating one common permit price.

Linking can take different forms. One-way linking allows companies in system A to buy permits generated in system B. With a two-way link, permits can flow in both directions across the linked market. Links can also happen indirectly via other market mechanisms, for example, if both ETSs are linked to the same offset crediting system such as the Clean Development Mechanism (CDM).



Why link?

One of ICAP's core objectives is to help alignment and linking of emissions trading systems, with a view to moving towards a global carbon market in the long term. Linking has a number of benefits:

1 Linking opens up access to more and potentially cheaper emissions reduction options. 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 companies across the linked market, which now face the same carbon price.

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

4 Linking can demonstrate climate change leadership and encourages international cooperation.

However, linking is not without challenges. Governments may need to adjust their ETS design in order to link and need to be ready to give up some sovereignty in managing the joint market. Furthermore, there may be concerns that companies, by buying permits from the other system, are effectively financing mitigation activities abroad, rather than taking climate action at home.

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Linking around the world

In 2014, California and Québec linked their ETS. Ontario briefly joined their carbon market, but exited again after a change in government. In Japan, Tokyo and the province of Saitama have been operating a joint carbon market since 2011. The European carbon market is also expanding: after the accession of Norway, Iceland and Liechtenstein to the European Union ETS in 2007, the EU ETS will link to the Swiss system from 2020. Last but not least, the ten states of the Regional Greenhouse Gas Initiative (RGGI) in the North East of the U.S. have been operating a joint carbon market since 2008, and more states seem set to join in the coming years.

2007

Norway, Iceland, Liechteinstein & EU

2009

Regional Greenhouse Gas Initiative (RGGI)

2011

Tokyo & Saitama

2014

Québec & California

2020

Switzerland & EU