Building blocks for a successful ETS

Insights from the EU perspective (and a bit beyond...)

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Contents

• Successful ETS?
  • Objectives? Conditions?

• How to achieve this?
  • Building blocks, iterative process

• Time dimension
  • What is needed when?
Straw poll:

Is the EU ETS successful?
When is an ETS successful?

- For example, opinions about whether the EU ETS is successful or not, vary widely

- In EU ETS review for Phase 4 revision (2015):
  - Objectives of EU ETS?
    - Short-term environmental objective: Emissions stay below the cap
    - Long-term environmental objective: Incentivise low-carbon development
    - Economic objectives: Establish functioning market, cost-effective reductions
  - Conditions: limit negative (side) effects
    - No *undue* distortion on competitiveness, limit carbon leakage, not punishing early action, etc.
How is that achieved?

• Short-term environmental objective: emissions below cap
  – Establish and communicate cap, obligations to participants
  – Issue allowances in line with cap
  – Track emissions robustly and timely
  – Enforce compliance

• Long-term environmental objective: low-carbon incentives
  – Sufficient carbon price level, i.e. ambitious cap
  – Limited flexibility provisions (credits, banking, borrowing)
  – Consistency with other policies affecting cap (e.g. RE policy, credit use) or price incentive (e.g. energy price controls)
  – Long-term certainty for participants on duration, clarity on timing evaluation, potential changes
  – Support for technology development, innovation
How is that achieved? – cont’d

• Economic objective: establish functioning market
  – Ensure demand and supply
  – Establish infrastructure (registry, trading platforms)
  – Ensure market access, liquidity
  – Establish market credibility: oversight, security
  – Limit market volatility, potential impact of major shocks

• Conditions: limit negative (side) effects
  – Competitiveness:
    – Use free allocation, carbon leakage provisions
    – Definition of scope, identification of participants
  – Early action: Use benchmarking
Timing: when what how?

• Experience and lessons learned from others’ is useful to identify pitfalls, potential solutions

• But cannot (fully) replace learning by doing
  – Own context, own people, own experience

• ETS will evolve over time
  – Ideally, all data, capacities, institutions, consistent legislation, infrastructure in place, ambitious cap, auctioning, a global carbon price (no leakage), fully passed on, with resources for limiting negative side effects
  – In the real world: What is crucial to get right from the start, what can develop, improve over time?

• Iterations are needed also within one cycle
  – E.g. cap-setting, definition of scope, identification of installations, data gathering, revision of cap to reflect scope, installation data
<table>
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<th>Building block</th>
<th>Phase I</th>
<th>Phase II</th>
<th>Phase III</th>
<th>Phase IV</th>
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<tr>
<td><strong>Cap</strong></td>
<td>Tightening cap</td>
<td>Tightening cap</td>
<td>Expanding scope</td>
<td>Tightening cap</td>
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<td></td>
<td>Identification of entities</td>
<td>Harmonising scope</td>
<td>Top-down cap, cons with other policies</td>
<td>Long-term trend cap</td>
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<tr>
<td></td>
<td>Banking, borrowing rules</td>
<td>Expanding scope</td>
<td>Limitation of credit use</td>
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<td></td>
<td>(no banking from pilot)</td>
<td>Limitation of credit use</td>
<td>Long-term trend cap</td>
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<td><strong>Allocation</strong></td>
<td>Developing allocation approaches, NAPs</td>
<td>Improving data basis GF</td>
<td>Harmonised allocation</td>
<td>Improving data basis BMs</td>
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<td></td>
<td>Data gathering grandfathering</td>
<td>(Some) harmonising MS allocation approaches</td>
<td>Harmonised NER rules</td>
<td>Updating BMs</td>
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<td>Avoiding competitiveness distortion</td>
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<td>Development of BMs</td>
<td>Limitation free allocation (carbon leakage)</td>
</tr>
<tr>
<td><strong>MRVA</strong></td>
<td>Development of EU MR rules</td>
<td>Harmonisation MS MRVA approaches</td>
<td>Increasing robustness</td>
<td>Improving MRVA for BM-based allocation</td>
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<td>Establishing institutions, responsibilities, legislation national level</td>
<td>Development of EU VA rules</td>
<td>Increasing harmonisation</td>
<td>Establishing MRVA for Production change-based allocation</td>
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<td>Development of MRVA regulations</td>
<td>Reducing admin burden</td>
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<tr>
<td><strong>Market functioning</strong></td>
<td>Establishment registry, Transaction log</td>
<td>Strengthening market oversight</td>
<td>Increasing user friendliness</td>
<td>Price control mechanisms (backloading, MSR)</td>
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<tr>
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<td>Market access, transparency rules</td>
<td></td>
<td></td>
<td>Strengthening market oversight</td>
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<tr>
<td></td>
<td>Definition of assets, accounting, tax issues</td>
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<td>Price floors (some MS)</td>
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# Building blocks for a successful ETS

<table>
<thead>
<tr>
<th>Building block</th>
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<th>Later</th>
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| Cap            | • Robust projections to understand effect of caps & flexibility provisions on carbon price & emissions  
                  • Understanding impact of banking & borrowing rules on market balance, timing of implementing measures  
                  • Consistent policy framework, reflected in cap level  
                  • Identification of all regulated entities, sources, emissions under the scope of the cap  
                  • Clear rules on banking, borrowing, validity of allowances | • Tightening of cap, reducing credit use  
                  • Widening of scope (+ corresponding cap adjustment)  
                  • Establishment of price control mechanisms (price floor, MSR)  
                  • Changing trading period length  
                  • Establishment of innovation incentives |
## Building blocks for success– Cont’d

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| Allocation     | • Ensuring coverage of all comparable entities  
• Availability of data required for allocation, in line with MRVA rules, definitions & system boundaries  
• Clear allocation rules and timelines, including treatment of new entrants, transfers, closures  
• Timely allocation | • Increasing stringency of allocation  
• Development, application of benchmark-based allocation approach  
• Development, use of auctions |
## Building blocks – Cont’d

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| **MRVA, compliance** | - Clear MRVA rules, responsibilities, procedures, timelines, templates, incl. pre-approved MP  
- Legislation establishing mandates, obligations, sanctions  
- Sufficient capacity to ensure (timely) compliance, enforcement  
- Timelines consistent with allocation cycle  
- Availability of registry, accounts | - Strengthening MRVA regime, reducing uncertainties, ensuring consistency  
- Ensuring 3rd party role in verification, availability necessary capacity  
- Reducing administrative costs  
- E-reporting |
| **Market functioning** | - Clear definition of characteristics, validity of tradeable assets  
- Clear rules, assuring access, preventing monopolies, preventing fraud and on who can trade  
- Establishment of regulating entity  
- Availability of trading platforms | - Increasing number & diversity of platforms  
- Development of more complex trading products, derivatives  
- Strengthening oversight and enforcement |
Conclusions

• Experience from others’ is useful but cannot (fully) replace (own) learning by doing

• Further lessons will be learned, each ETS will evolve over time

• Important to accommodate this learning in design and implementation choices
  – Learning phase, separate from subsequent phases => limited/no banking!
  – Allow for steps, iterations (also within one cycle) to ensure the right data are used for decision-making:
    – Legal basis for requiring data submission
    – Full installation level data set for cap-setting
    – Pre-approved monitoring plan for MRV
Conclusions – Cont’d

• The perfect can be the enemy of the good
  – Starting with grandfathering based on solid data may be better than a BM-based approach without a robust basis. First years can then be used to collect required data, develop BM approach

• First priority: elements with potentially significant, long-lasting impact:
  – Supply/demand balance, unequal treatment, system/market credibility

• Managing expectations is important
  – If rules and approaches are transitional, make this clear upfront to participants
  – ‘Taking away’ rights, assets later is more difficult if unexpected, unannounced
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