

# **Linking Heterogeneous Climate Policies (Consistent with the Paris Agreement)**

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**Article 6 and North American Linkage: Finding Synergies**

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# Key Challenge for Eventual Success of Paris Agreement

- Can Paris Agreement, with NDCs *anchored* in domestic political realities, *adequately* address emissions with sufficient ambition?
- Are there ways to enable and facilitate *increased ambition* over time?
- **Linkage of regional, national, and sub-national policies can be part of the answer** – connections among policy systems that allow emission reduction efforts to be redistributed across systems
  - Linkage is typically framed as between cap-and-trade systems...
  - ... but regional, national, and sub-national policies will be highly *heterogeneous*

# Heterogeneous Climate Policy Instruments

- Major CO<sub>2</sub> cap-and-trade regimes in place & announced
  - European Union Emissions Trading System, \$12/ton (2005-)
  - New Zealand Emissions Trading Scheme, \$13/ton (2008-)
  - U.S. Regional Greenhouse Gas Initiative, \$4/ton (2009-)
  - California's AB-32 GHG Cap-and-Trade System, \$14/ton (2013-)
  - Quebec Cap-and-Trade System, \$14/ton (2013-)
  - Korea's Emissions Trading Scheme, \$21/ton (2015-)
  - Ontario Cap-and-Trade System, \$14/ton (2017-)
  - China's national CO<sub>2</sub> cap-and-trade system (2020?-)
- Selected carbon (and related energy) taxes
  - Finland (1990), Norway (1990), Sweden (1991), Denmark (1992), Costa Rica (1997), British Columbia (2008), Switzerland (2008), Ireland (2010), Iceland (2010), Japan (2012), United Kingdom (2013), Mexico (2014), Chile (2014), France (2014), South Africa (2016), Alberta (2017)
- Many other jurisdictions will *not* employ carbon pricing, but will use *performance standards* and/or *technology standards* instead
  - Less cost-effective than carbon pricing
  - Muted/distorted price signals
  - Still, in some cases will place an implicit shadow-price on carbon

# Why Focus on Linkage?

- Potential for cost savings by allowing firms to take advantage of lower cost abatement opportunities in other jurisdictions;
- Linkage may improve functioning of cap-and-trade markets:
  - reduce *market power* by enlarging the trading market; and
  - reduce total *price volatility* by thickening markets;
- Political benefits to linking parties
  - Sign of “momentum” as political jurisdictions band together
  - Potential to influence non-linking countries to participate
- Administrative economies of scale
  - Knowledge sharing in designing & operating controls
  - Shared administrative and oversight costs
- Allow for UNFCCC’s CBDR *without* sacrificing cost-effectiveness

# Concerns with Linkage

- Distributional impacts
  - Redistribution within jurisdictions
  - Redistribution across jurisdictions
  - A political problem
- Automatic propagation of some design elements
  - Weak design in one jurisdiction affects prices and quality of program in all jurisdictions
  - Price shocks can propagate through all linked jurisdictions
- Decreased autonomy
  - Rules set jointly by all linked parties
  - Leader-follower dynamic

# Hard and Soft Linkage

- *Hard linkage*: a formal recognition by a GHG mitigation program in one jurisdiction of emission reductions undertaken in another jurisdiction for purposes of complying with the first jurisdiction's mitigation program
- *Soft Linkage*: An agreement (explicit or implicit) to harmonize carbon prices either at a level or within overlapping bands
  - Carbon taxes set at a given rate (or within a target band)
    - For example, a “carbon club”
  - Cap and trade programs with price collars
  - Mixtures of the two

# Linkage and the Paris Agreement

- *Article 6.2* – cooperative approaches involving *Internationally Transferred Mitigation Outcomes (ITMOs)*
  - can function as an international accounting mechanism
- *Article 6.4* – mechanism to contribute to emissions mitigation and support sustainable development

# Three Major Categories of Heterogeneity

- **Heterogeneous Instruments**
  - Cap-and-Trade
  - Emission Reduction Credit (Offset)
  - Tax
  - Performance Standard
  - Technology Standard
- **Heterogeneous Jurisdictions/Geographic Scope**
  - Regional , National, and Sub-National
  - Status under the Paris Agreement: Party/non-Party
- **Heterogeneous NDC Targets**
  - Hard (mass-based) emissions cap
  - Relative mass-based emissions cap (relative to BAU)
  - Rate-based emissions cap (per unit of economic activity or per unit of output)
  - Other, non-emissions caps, such as penetration of renewable energy sources
  - *Also*, differences in base year, target year, sectors, GHGs, GWPs, & conditionality



# Exploring Linkage: Five Cases

Case	Categories of Heterogeneity				
	Policy Instrument	Jurisdiction/Scope		Target	
		Level of Jurisdiction	Status under Paris Agreement	Policy Instrument	NDC
1	Cap-and-Trade	National	Party	Mass-Based	Absolute GHG
	+ Cap-and-Trade	+ National	+ Party	+ Mass-Based	+ Absolute GHG
2	Carbon Tax	Sub-National	In a Party	Mass-Based	Absolute GHG
	+ Cap-and-Trade	+ Sub-National	+ in a Party	+ Mass-Based	+ Absolute GHG
3	Cap-and-Trade	Regional	Party	Mass-Based	Absolute GHG
	+ Cap-and-Trade	+ Sub-National	+ in a Non-Party	+ Mass-Based	+ N/A
4	Performance Standard	National	Party	Rate-Based	Absolute GHG
	+ Cap-and-Trade	+ National	+ Party	+ Mass-Based	+ Relative GHG
5	Carbon Tax	National	Non-Party	Mass-Based	N/A
	+ Carbon Tax	+ National	+ Non-Party	+ Mass-Based	

# Case 1: Cap-and-Trade + Cap-and-Trade

- **Linkage straightforward, but specific design elements can raise *concerns*, if *not* impediments to feasibility**
- **Design Heterogeneity**
  - Difference in allowance prices
  - Difference in scope of sectoral coverage
  - Difference in point of regulation (upstream vs. downstream)
  - Difference in point of allocation (upstream vs. downstream)
  - Difference in nature of allocation (auction vs. free distribution)
  - Difference in monitoring, reporting, & enforcement provisions
  - Difference in cost-containment provisions (offsets, banking, borrowing, price floor, price ceiling)

Example:  
New Zealand + Switzerland

# Cap-and-Trade Design Heterogeneity

- Difference between allowance prices ↑
  - Cost savings ↑
  - Lower or higher price can impair policy objectives (e.g., technological change)
  - Price↑ in system prone to *emissions leakage* → global emissions↑
  - Potential increase/reduction in co-benefits as emissions reductions reallocated
  - Distributional implications: winners & losers in both systems
  - Capital flows can be political issue
- Difference in scope of sectoral coverage
  - Linked systems need *not* cover same sectors (and single-sector system is automatically linked to all sectors covered by other system)
  - But scope of coverage can affect difference in allowance prices
- Difference in point of regulation (upstream vs. downstream)
  - Concern about double-counting of emissions when fuel in upstream system is used in downstream system, ...
  - But issue arises whether or not systems are linked
  - Solution: upstream system excludes exported fuel from allowance requirement

# Cap-and-Trade Design Heterogeneity (continued)

- Difference in point of allocation (upstream vs. downstream)
  - Affects distributional implications in both systems
- Difference in nature of allocation (auction vs. free distribution)
  - Normally does *not* affect allowance price/opportunity cost, but affects distributional implications in both systems
  - Output-based updating allocation (for competitiveness) → total costs can ↑
- Difference in monitoring, reporting, & enforcement provisions
  - Trading can increase total emissions; increase price volatility (& hence costs)
- Different cost-containment provisions: offsets, banking, price floor/ceiling
  - Automatic propagation from one system to the other

# Case 1: Legal Questions

- **Potential (legal) heterogeneity of instrument:**
  - Possible differences in the degree of formality and normativity:
    - CAT is set out in statutory legislation vs. executive rules
    - CAT is mandatory vs. voluntary
  - Less formal and/or voluntary CAT will offer less predictability and accountability than more formal and/or mandatory instruments → risk potentially ↑
- **Potential (legal) heterogeneity of target:**
  - Again possible differences in the degree of formality and normativity
  - Aspirational target or target adopted by political program will offer less credibility and accountability than statutory and/or legally binding target → risk potentially ↑
- Some **linking mandates** specify substantive and formal robustness criteria re. instrument and/or target (e.g. Calif. SB 1018: “equivalent to or stricter”, ensuring “enforcement of applicable laws”; EU ETS Dir. Art. 25 (1a): “mandatory” w. “absolute ... caps”)
- **... but no heterogeneity of jurisdiction**

# Case 2: Sub-national Carbon Tax + Cap-and-Trade

Example:  
British Columbia and Tokyo

- **Direct two-way linkage feasible via Emission Tax Payment Credits (ETPCs)**
  - Linkage of Tax + CAT the same as CAT-CAT link where one system has a very narrow price collar
  - *Previous issues* of design heterogeneity in CAT-CAT link also apply here, *plus some special considerations ...*
- **Key Factors specific to Carbon Tax-CAT linkage**
  - Unrestricted linkage turns a cap-and-trade system into a tax – two concerns:
    - Absolute limit on emissions in CAT country defeated by link to Tax country
    - Tax revenues in Tax country can be reduced

## Case 2: Legal Questions

- **Heterogeneity of instrument & target:**
  - Some linking mandates specify eligible type of instrument to link to (e.g. EU ETS Directive Art. 25 (1a): linking only to “greenhouse gas emissions trading systems”)
  - Otherwise same considerations as under Case 1
- **Heterogeneity of jurisdiction:**
  - Usually lacking treaty-making powers, subnational entities may have to rely on less formal arrangements to link, e.g. an MoU → predictability, accountability pot. ↓
    - For the United States: US Constitution art. II § 2, cl. 2; art. I § 10; clarified by SCOTUS in *Virg. v. Tenn.* (1893); exemptions may apply e.g. on local issues
    - For Canada: more complicated, but ultimately devolved on federal exec. branch
    - CA-ON-QC Linking Agreement: “does not, will not and cannot be interpreted to restrict, limit, or prevail over ... each Party’s sovereign right and authority”
  - Despite growing role for Non-State Actors in climate cooperation, only countries can be Parties to the Paris Agreement and thus account for ITMOs under Art. 6.2
    - Subnational jurisdictions in countries that are Parties to the Paris Agreement have to rely on their country to approve ITMO use towards NDC (Art. 6.3)

## **Case 3: Regional Cap-and-Trade + Sub-National Non-Party Cap-and-Trade**

European Union  
And  
California

- **Policy Instrument: all the same issues/concerns as in Case 1**
- **Heterogeneity of instruments presents no insurmountable impediments**



# Case 3: Legal Questions

- **Treatment under Article 6 of the Paris Agreement:**
  - Nothing precludes *non-Party* from using emission reductions achieved by a Party to Paris Agreement (although it is unclear whether the Party has to agree, Art. 6.3)
    - Party may not include that mitigation in reporting to UNFCCC (double-counting)
  - The real issue is how to treat reductions achieved by a *non-Party* that are claimed by a Party to the Paris Agreement
    - Conceptually similar to the CDM (i.e. CERs from non-Annex I Parties without QELROs under the Kyoto Protocol)? Maybe, but that sets no legal precedent
    - Art. 6 wording is interpreted by some to mean that transfers (or at least use towards NDC achievement) is limited to Parties, but the text is *inconclusive*
    - CMA guidance on Art. 6.2 may clarify this question, although its mandate is limited. In the absence of explicit clarification, it will be difficult to prevent
  - A revival of the idea of “gateway” solutions (net unidirectional flows)?

# Common Threads and Policy Implications

- Most features of heterogeneity *do not present insurmountable obstacles* to linkage,
  - but *some present real challenges*,
  - and indicate *need for specific accounting guidance* if linkage includes *transferred ITMOs to achieve NDCs*.
- Article 6.2 provides mandate to adopt guidance for *robust accounting to avoid double-counting*
  - But *less clear* whether guidance can stipulate provisions that go beyond accounting issues, such as on matters of environmental integrity.

# Accounting Treatment of ITMO Transfers and Use

- How are adjustments made for ITMO transfers? Two possible approaches:
  - ITMOs added to or subtracted from inventory emissions → adjusted emissions
  - ITMOs added to or subtracted from NDC target level → adjusted target
- Quantifying ITMOs
  - Account for differences in assumed GWP
  - Account for heterogeneous base years and vintages of targets/outcomes
  - Account for different target types, such as absolute and relative GHG targets
- Broader questions that bear on accounting:
  - Nature & scope of (undefined) ITMOs
  - Tracking of ITMO transfer via registry
  - Issues regarding ITMO transfers to/from non-Parties

# The Outlook for Heterogeneous Linkage Consistent with the Paris Agreement

- Negotiators have opportunity to *define clear & consistent guidance* for accounting of emissions transfers under Article 6
  - *Robust accounting framework* for ITMO transfers & can foster *better linkage* of climate policies across jurisdictions
- *But* if guidance extends much beyond basic accounting rules,
  - ... restrictive requirements could *impede* effective linkage
- True to the spirit of the Paris Agreement, *less may be more!*
- So, combination of *common accounting rules* and *absence* of restrictive criteria & conditions can accelerate linkage, ...
  - ... and allow for *broader & deeper climate policy cooperation*,
  - ... and – most important – thereby *increase* the latitude of Parties to *scale up the ambition* of their NDCs.

# For More Information

## Harvard Project on Climate Agreements

[www.belfercenter.org/climate](http://www.belfercenter.org/climate)

## Harvard Environmental Economics Program

[www.hks.harvard.edu/m-rcbg/heap](http://www.hks.harvard.edu/m-rcbg/heap)

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