

## Rescued Down Under: The Linking of the EU ETS with the Australian CPM

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Amid the recent frustrations of the carbon markets, on the 28th August 2012 arrived the exciting announcement of the intention of the EU Emissions Trading Scheme (the "EU ETS") to link with the Australian Carbon Price Mechanism (the "CPM"). To say that this development came as a welcome surprise to the market would be an understatement.

According to the announcement, the linkage will occur in two stages: a partial one-way unilateral link allowing transfers of EU allowances ("EUAs") to and use the use of EUAs by Australian compliance entities commencing on 1 July 2015 and a full two-way bilateral link providing for full mutual recognition of each other's units commencing on 1 July 2018. The unilateral link will not require further legislative approval from the respective government legislatures but the bilateral one will need approval both in the EU and Australia. This client alert explores some of the potential issues and questions arising from these proposals.

### The unilateral link

With the potential for the unilateral link to occur within a relatively short time frame, the market is likely to see a direct impact of this announcement relatively soon; in particular, when the three-year forward curve is considered. The obvious commercial question to be asked is, what will this do for EU ETS demand? No doubt market analysts will already be working out the factors that will dictate the answer to that question.<sup>1</sup>

However, in the legal and structural context, the key themes of the partial linkage are summarised below:

- EUAs will be available to Australian compliance entities under the CPM from 1 July 2015;
- Compliance usage restrictions of 12.5% will be placed on the quantity of Kyoto units (i.e. CERs and ERUs) that may be used by CPM compliance entities from 1 July 2015;
- No more than 50% of an entity's compliance obligations can be met through the use of international emission units (including EUAs); and
- There will be no floor price in the CPM while the cap will be referenced against the expected 2015-16 EUA price.

### The timing

The start date of 1 July 2015, of course, coincides with the start of the Australian financial year and the first date of the "flexible" (i.e. cap-an-trade) period in the CPM.<sup>2</sup> Perhaps helpfully, this is also likely to be after the end of the true-up period for compliance under the first commitment period of the Kyoto Protocol. The Australian government has not finalised its agreement to participate in the second commitment period under the Kyoto Protocol. Does a linkage with the EU ETS make such a position now less or more likely? If reducing the inconsistencies between the EU ETS and the CPM were a significant factor weighing on the mind of the Australian delegation in Doha then, logically, participation would be more likely now than before.

## **Registry Connectivity**

Australian compliance entities under the CPM are going to be allowed to open accounts in the Union Registry with immediate effect. There is no mention, in the joint EU-Australian announcement, of the position of non-compliance entities such as banks and market-makers. The current EU Registries Regulation<sup>3</sup> does not necessarily restrict such applicants but the individual rules of an EU Member State may. For example, the current requirements for opening an account in the Union Registry subject to the supervision of the UK national administrator, include a requirement that the applicant has a current bank account in an EEA or EU Member State. No doubt such requirements will have to be revisited by such Member States or the Commission will have to amend the Registries Regulation to specifically require such registry access for certain qualifying Australian entities.

## **Back-loading and auctioning**

The EU ETS-CPM link is expected to benefit Australian compliance entities in a number of ways; but most significantly, by linking their compliance cost to the EU ETS, it is anticipated that the cost of compliance will drop significantly for Australian compliance entities in their 'flexible' period. The EU ETS-CPM link certainly helps the EU ETS to find a market in which to dispose of some of its excess allocation of EUAs. According to various sources, Australian demand for international offsets between 2015 and 2020 can be anything from as little as 120m tonnes to 550m tonnes.<sup>4</sup> Although this is not likely to cause a significant dent in the large excess believed to exist in the third phase of the EU ETS, it may make some difference where, for political reasons or otherwise, the set-aside quantities determined in the Commission's auction back-loading proposals are, for example, 900m tonnes instead of 1.2b tonnes. It also helps explain why the back-loading proposal, which absent any other significant legislative and policy change<sup>5</sup> anticipated the back-loaded auction quantities of EUAs coming back into the market between 2018-20, may not be a matter of just simply delaying the inevitable. On the assumption that EUA prices remain below Australian carbon prices, some EUAs are likely to flow into the CPM to meet Australian compliance demand.

In the meantime, it looks like Australian entities will not be able to participate, under the terms of the Auctioning Regulation<sup>6</sup>, directly in the EU ETS auctions for Phase 3. This means an Australian entity's participation in the EU ETS during the unilateral linking period is going to be through the secondary market only.

## **The aviation challenge**

Australia has been one of the countries opposing the inclusion by the EU of the international aviation sector within the scope of the EU ETS.<sup>7</sup> Under the CPM, international aviation is not subject to a fuel tax and is therefore not affected by the carbon price under the CPM. Does the linkage between the EU ETS and the CPM therefore now amount to an endorsement of the EU ETS position on aviation by the Australian government? Given the immediate nature of the unilateral linkage and the proposal for eventual full bilateral way linkage, mostly for political reasons, it is difficult to see the EU and Australian governments maintaining conflicting positions on such a significant design aspect of the EU ETS.

## **Kyoto Protocol impact**

The CPM and the EU ETS are of course, already linked via the International Transaction Log for trading Kyoto units. Whether an Annex 1 Country, that doesn't sign up to a second commitment period under the Kyoto Protocol, will continue to benefit from the ability to directly participate in Kyoto projects is yet to be determined. If Australia doesn't commit to a second commitment period but the EU does, even if Australian entities are not able to participate directly in Kyoto projects, via linking, they should be able to 'piggy-back' off the EU Kyoto participant status to access Kyoto units at "primary" market prices.

Although the EU ETS and the CPM both recognise Kyoto units as compliance tools in their respective schemes, the trend in the EU ETS has for sometime now been one of reduced dependency. The 12.5% annual limit to be introduced in the CPM on the use of Kyoto units, is indicative of a similar trend. Add to this, the parallel and obvious point arising from the intention to enable EUAs being used in the Australian National Registry of Emissions Units from as early as mid-2013, and it becomes fairly obvious that because of issues such as double counting, the EU and Australian government's international greenhouse gas emission reduction target commitments are probably now locked in until 2020.

## **The bilateral link**

The key themes of full linkage are summarised below:

- Full two-way linking agreement with expected commencement from 1 July 2018
- Co-ordination of policy issues in the following areas:
  - Measurement, reporting and verification arrangements;
  - Types, quantities and other relevant aspects of third party units that are mutually recognised (e.g. recognition of the same types of CERs and ERUs);
  - The role of land-based domestic offsets (e.g. Australian carbon credit units generated through its Carbon Farming Initiative);
  - The implications for supporting competitiveness of EU and Australian industries in particular sectors exposed to the risk of carbon leakage; and

- Comparable market oversight.

## Legislative uncertainty

Both the EU Commission and the Australian government will have to seek mandates from their respective legislatures to enable full linkage between the two schemes. In the EU ETS, although not without doubt, it seems more likely that such a mandate will be forthcoming; after all, the twenty-seven Member States are already together linked to three EEA countries<sup>8</sup> and they are in negotiations with Switzerland. Given the troubled parliamentary waters through which the Australian Clean Energy Act 2011 sailed before becoming law and the explicit threat of revocation of the Act from the current party in opposition, the ability to achieve a mandate in Australia or to find the mutual agreement on the policy issues referred to in Box 2 above, cannot be treated as absolute or certain.

## Impact on the UNFCCC negotiation process

Whilst the linkage between the two schemes is a very positive and important development, it also confirms the end of the EU and the Australian support for a future international agreement under the Kyoto Protocol.<sup>9</sup> This is however, not inconsistent with the outcome of the Durban platform.<sup>10</sup> Although, this does not detract from their respective commitments to negotiate a new international agreement as envisaged in the Durban platform, it does leave them less vulnerable to such an agreement failing to materialise. The fallback for an overarching international agreement was always going to be a series of bilaterally or multilaterally linked schemes. By establishing a pathway to such linking, Australia and the EU will be ahead of the curve and this will no doubt influence their respective negotiating positions under the UNFCCC negotiation process. The EU has retained an open mind on potential linkages with California, RGGI and even sectoral-based linkages with China; whereas Australia has looked at potential for linkages with the New Zealand scheme.

One of the advantages of an overarching international agreement to address climate change is, of course, the harmonisation and consistency of the international effort in achieving the 2°C ambition.<sup>11</sup> A harmonised approach has the benefit of being more efficient and economical. Ad-hoc linking of various schemes, with local ambitions and structural quirks, that are not coordinated with international efforts, is always going to be second best. However, in an environment where no political appetite exists for a common and unified approach, such ad-hoc linkages remain the best route forward.

**Harmonisation of policy issues** The EU ETS and the CPM were obviously designed with their respective local sensitivities and ambitions in mind. These are reflected in the variations of design features the two schemes have – e.g. in their respective coverage of compliance entities, emission reduction goals, reporting and verification stringencies, rules on banking, length of compliance periods etc.

Taking a simple example of the policy discussions that are likely to follow, the compliance periods of the CPM are five-year rolling periods which run from 1 July to 30 June whereas the EU ETS has an eight year period running from 1 January to 31 December. This begs the question whether, in the longer term (i.e. after 2020), there will be an attempt to align the lengths

of the compliance periods of the two schemes or even the compliance deadlines for the two schemes. Although this is not a necessary aspect of linking, the different compliance deadlines and lengths will make determinations of supply and demand and their impact on pricing more challenging. It could also trigger specific peak-periods in each of the EU ETS and the CPM determined by their respective compliance deadlines. Whether the length of the compliance periods under a Durban platform inspired international agreement, due to start from 2020, ultimately has any impact on the choice of length of compliance periods within the EU ETS or the CPM, is yet to be seen.

Another area where policy consistency will be relevant is market oversight. The EU is about to treat an EUA as a financial instrument under the new Markets in Financial Instruments Directive. This classification has a regulatory impact on who can or cannot deal in an EUA absent specific authorisation from a financial regulator or because it benefits from a specific exemption. In Australia, an Australian Carbon Unit ("ACU") is a 'financial product' under the Corporations Act 2001 and the Australian Securities and Investments Act 2001 which, similarly, requires persons providing financial services in relation to ACUs to be licensed. The full bilateral link will need to address the recognition of any EU authorised persons in Australia and vice-versa. In the absence of passporting arrangements, bilateral recognition will have to be expressly negotiated.

## Conclusion

The linkage of the two schemes helps resuscitate the belief in "cap and trade" as the best tool for delivering reductions of green house gasses in the most cost-effective manner. It rescues the debate away from tax and provides a real psychological boost to a beleaguered EU ETS market. The EU ETS-CPM linkage will lead to a larger and more liquid carbon market which should drive the allocation of resources towards the place where the cost of abatement of a tonne of carbon will be lower, more efficiently. This should create a greater range of abatement opportunities which should reduce the cost of compliance. In effect, this should lead to a single price for a tonne of carbon in the EU ETS and the CPM.

However, in linking any two schemes one of them will initially always be the winner. This linkage is predicted to bring down the cost of compliance for Australian compliance entities with EU ETS prices effectively setting the floor price in the CPM. The success of the establishment of a single carbon price, of course, depends on the achievement of the necessary minimal harmonisation to avoid price distortions caused by such linking. These design features, to be negotiated between now and 2018, will ultimately determine the success of the EU ETS-CPM linkage.

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<sup>1</sup> In fact, according to the "Bloomberg Brief: Clean Energy & Carbon" of 28 August 2012, analysts are expecting no more than an annual maximum demand of 14 million tonnes per year during the unilateral linking period.

<sup>2</sup> The CPM has a fixed price taxation approach from 1 July 2012 until 30 June 2015.

<sup>3</sup> Commission Regulation (EU) No. 1193/2011

<sup>4</sup> Of which we now know no more that 12.5% may be made up of Kyoto units.

<sup>5</sup> For example, by removing a number of EUAs from the market.

<sup>6</sup> Commission Regulation (EU) No. 1031/2012 as amended by Commission Regulation (EU) No.

1210-2011.

<sup>7</sup> Australia did not participate in the Delhi and Moscow meetings of the informal 'coalition of the unwilling' (i.e. those countries that have signed declarations opposing the EU ETS) but did participate in the August 2012 Washington meeting.

<sup>8</sup> Iceland, Norway and Liechtenstein.

<sup>9</sup> This does not necessarily prejudice the EU position on a second commitment period under the Kyoto Protocol but the Australian government is yet to confirm its position.

<sup>10</sup> Decision 1/CP.17 "a process to develop a protocol, another legal instrument or an agreed outcome with legal force under the Convention applicable to all Parties through a subsidiary body under the Convention hereby established and to be known as the Ad Hoc Working Group on the Durban Platform for Enhanced Action" by 2015.

<sup>11</sup> The goal of limiting the impact of the increase of harmful greenhouse gases in the atmosphere to 550 ppm with a view to limiting the change in average global temperature to 2°Celsius.

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