CASE STUDY: LINKING THE SWISS AND EU ETS

Dominik Englert writes about why "adding" 6 million tCO_2 to 2 billion tCO_2 is harder than it seems

What a shock in May 2014: €33.50 ($37) for a single tonne of CO_2?[1] Suddenly, Switzerland's emissions trading system (CH ETS) had become the most expensive worldwide. Even if the price for Swiss emission allowances (CHU) has considerably decreased since then – it is currently about €11/CHU – this soar in price fuelled calls for a link between the CH ETS and the EU ETS.

The idea of linking the Swiss ETS with its EU counterpart emerged in 2008 and represented the first attempt to connect two independent trading systems. While the CH ETS covers only 55 companies emitting a combined 6 million tCO_2 per year, the EU ETS covers about 12,000 installations and caps around 2 billion tCO_2 annually.[2] This striking difference in scale has direct implications on the respective expectations of a link.

SWITZERLAND'S ECONOMIC GAINS FROM A LARGER CO2 MARKET

Switzerland's strong interest in a linkage is mainly driven by economic motivations. Due to its small size, the CH ETS suffers from major deficiencies. First, public trading of CHUs is non-existent and transactions of Swiss emissions allowances only take place over-the-counter. At the time of writing in September 2015, the official exchange had not registered a single trade since its inception in 2011.[3]

Second, as Swiss companies usually apply modern and efficient technologies already, they often feel deprived of low-cost emission reduction opportunities. Third, the CHU price has always ranged significantly above the price for an EU emissions allowance (EUA) – as much as five times higher – which leads to a significant competitive disadvantage.

Consequently, Switzerland expects that linking will bring a more liquid market, greater flexibility in exploiting emissions reduction potential and a level playing field for national companies and their European competitors.

THE EU'S POLITICAL MOTIVATION FOR A LINKING

In return, the economic impacts on the EU ETS would be negligible. Once linked, the CHU price would instantly adapt to the EUA price level. Therefore, the EU's motivation for a linking is more coloured by political considerations.

In the global political arena, the linking represents an important symbolic act. After the successful example of California and Québec, linking two more independent trading systems with each other would show again that a bottom-up approach in global carbon pricing is feasible and should hopefully invite others to follow suit.

Additionally, the linking would allow the EU to eliminate a blind spot in European carbon legislation with regard to aviation: currently, CO_2 emissions from the aviation sector are not capped by any specific legislative measure in Switzerland. The prospective linking would imply that Swiss airports would no longer serve as a safe haven for intra-European flights.

CHANGES AND COMPROMISES FOR FULL COMPATIBILITY

Having started as a voluntary programme in 2008, participation in the Swiss system was introduced as an alternative for national companies paying a mandatory CO_2 levy of €22/tCO_2.[4] From the outset, this system differed considerably from the EU's. The free allocation was based on a company's emissions reduction potential from both a technical and an economic point of view. Additionally, firms could temporarily use removal units from carbon sink projects. Finally, the penalty regime, where the CO_2 levy plus tax had to be paid retroactively in case of non-compliance, served as a *de facto* price cap.[5]

As a consequence, Swiss policy-makers had to remove these potential barriers to linking through a complete revision of the CO_2 Act in 2011. First of all, the ETS became mandatory for large emitters from 2013 to 2020. Furthermore, free allocation was subsequently based on the same efficiency benchmarks as in the EU and the use of international offsets was harmonised with the EU's practice. Finally, the new penalty mechanism requires Swiss companies to pay a penalty of €114.50/tCO_2 and hand in the missing emissions allowances at a later point of time.

A POTHOLED ROAD TO A FINAL AGREEMENT

So why is it that, despite the enhanced compatibility, a link has not been

THE LINKING ASPIRATIONS BETWEEN THE CH ETS AND THE EU ETS SHOW THAT TECHNICAL COMPATIBILITY MUST BE CONSIDERED

established yet? In March 2015, the seventh round of high-level negotiations that formally started in 2011 was completed and both parties confirmed that a final agreement was in close reach. Only minor technicalities like the regulatory and commercial modalities of auctioning CHUs in a non-discriminatory way remain. But, as is often the case, the major obstacle is more political than technical.

From the very beginning, the consideration of aviation in a linked market has been controversial. Many Swiss stakeholders opposed the idea of including aviation into the CH ETS and, with constant changes to the stop-the-clock proposal over the years, the EU has not necessarily facilitated a common position either.

The entire negotiation process has also been suffering from a general political crisis between Switzerland and the EU since February 2014, when the Swiss people voted in a referendum for the reintroduction of immigration quotas in Switzerland. As a consequence, the EU – for which freedom of movement represents one of its core achievements – temporarily suspended all negotiations on any bilateral agreements. Even if the talks have been resumed in the meantime, this sword of Damocles remains.

LESSONS LEARNED

Given the small size of the Swiss ETS and Switzerland's membership in the European Economic Area for more than 20 years, a fast and efficient conclusion of any linking negotiations was expected. Yet, the past five years have proven this idea overoptimistic.

The linking aspirations between the CH ETS and the EU ETS show that technical compatibility must be considered as a necessary condition. However, it clearly does not represent a sufficient condition *per se*. While technical issues can usually be resolved over time, keeping constant rational sobriety in the talks represents a big challenge for any linking projects worldwide.

Even if the respective gains are self-evident for both sides, the promoters of linking should always try to focus on the project itself, keep it separate from any possible proxy conflicts and avoid that the linking becomes a political playground. Admittedly, this is difficult in a CO_2 market that is highly political by definition. Nevertheless, it is recommended to limit any political discussions to the actual cause. This would considerably help the carbon pricing mechanism of international emissions trading to unfold its full potential by following a simple, but convincing logic: the bigger, the better.

With a background in economics and international relations, ***Dominik Englert*** *has worked since 2011 for First Climate, an internationally renowned consultancy based in Zurich and Frankfurt. Within this context, he has provided advisory services on CO_2 markets, carbon policy and climate finance for public organisations and industrial companies on a global scale. In November 2015, he starts a new position at the World Bank in Washington DC, dealing with climate risk and disaster management.*

(1) Swiss Emissions Trading Registry (14.09.2015). Auctions. (2) Swiss Federal Office for the Environment (24.04.2015). Linking the Swiss and EU emissions trading schemes. (3) OTC-X (4) The CO2 levy was raised to €49/tCO2 in 2014 and it will further increase to €77/tCO2 in 2016. (5) Carbon Market Watch (May 2015). Towards a global carbon market – Prospect for linking the EU ETS to other carbon markets.

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