

# Administrative and Compliance Issues Related to International Emissions Trading

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## 1 Introduction

In the former chapters in this part on IET several authors have addressed issues that are related to the design of a national trading regime that could be extended to an international emissions trading system. This chapter provides some suggestions that are related to the establishment of an administrative body for an international emissions trading (IET) regime, the issue of compliance, and the possible future participation of developing countries in an IET system.

## 2 A Central Administrative Body

This section proposes the establishment of a central administrative body for IET. Such a body would have to be established under the CoP/MoP and would be responsible for the maintenance and operation of the regime. The functions of the Body could be the following. First, the central administrative body would be responsible for the issuing of the permits on the basis of the Parties' assigned amounts by adding serial numbers to each unit of Annex B Parties' tradable assigned amount. Note, however, that it is not proposed here to give the Body decision-making authority with respect to the level of Parties' assigned amount, but to let it implement the system given the assigned amounts agreed upon under the Kyoto Protocol or any future Protocol (Amendments). Under the central administrative body a tracking system for emissions trading could be established, which could be used to double-check the information provide by each Party.

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On the basis of the information reported by the Parties, the central administrative body will be able to match the allocation of assigned amount units, check the emissions monitoring data, and to judge whether a Party is in compliance or not. In case it turns out that a Party has not complied with its QELRC, the body can take appropriate measures on the basis of the non-compliance procedures to be established under the Kyoto Protocol Amendment. The CoP is expected to take a decision on the compliance procedures under the Protocol at the first session of CoP/MoP.

It is important that the proposed central administrative body should not have a huge administration and immoderate bureaucracy. By making use of electronic systems for the administration of the transfer of assigned amount units from one Party to another an accurate system could be established at low administrative costs. By doing so the administrative body can monitor the market without interfering in it. Furthermore, the central administrative body is not expected to be given a decisive role in case some critical issues have to be resolved, like for example that of how to convert CERs from CDM projects and ERUs from JI projects into assigned amount units. In such cases, it is recommended to leave the decision-making responsibility with the CoP/MoP.

### **3 Non-Compliance Provisions**

The compliance procedures (Article 18) under the Kyoto Protocol are to be decided upon at CoP/MoP 1. Being an intergovernmental treaty, the Kyoto Protocol requires a compliance procedure with more or less “encouraging penalties.” It seems unrealistic to establish a system with financial penalties (fine) since there is no governmental body available to enforce Parties to pay fines, as is for example possible under national governments. In the framework of Article 18, the Kyoto Protocol is expected to formulate a set of procedures to be applicable according to the level and kind of non-compliance, as is the case under the Montreal Protocol.

However, the biggest difference between the Kyoto Protocol and other (regulated) protocols is the fact that *a Party's non-compliance implies that such a Party cannot purchase enough*

*assigned amount units on the market.*<sup>2</sup> In other words, if the market would work properly, there would be a sufficient supply of assigned amount units, so that Parties can comply with its QELRC by purchasing excess supply from other Parties.<sup>3</sup> This implies that a market-based approach might be suitable for the non-compliance procedures as well.

Below, a set of procedures is proposed of what a non-compliance regime in case of seller liability could look like:

1. The Party will *annually* report to COP/MOP on its compliance possibility and outlook based on self-judgement. At the same time, an estimation committee of the central administrative body examines/verifies this on the basis of a certain methodology.<sup>4</sup> However, the decision on whether or not the Party is in compliance will be decided upon after the commitment period of five years is over.
2. The Party must report within six months after the end of each commitment period its total GHG emissions and the serial numbers of the assigned amount units that have been transferred via IET
3. In case a Party is in non-compliance it could be permitted to use a limited part of the assigned amount of a future commitment period. For such a treatment an interest rate should be set and the added amount will be subtracted from the assigned amounts in the following commitment period.
4. The amount which cannot be borrowed from the future commitment period, because of the limitation mentioned above, must be compensated by the Party by purchasing (not by paying a penalty) non-tradable permits from the central administrative body at a fixed, high price (*e.g.*, US\$500/tC eq).<sup>5</sup> The latter type of permits could, the administrative body could pool a certain amount as a buffer, and/or the Body covers the shortage by purchasing the permits in the following period from the market using such revenue. This procedure has a

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<sup>2</sup> This implies that the market does not work properly, *i.e.*, there are not enough permit producers in spite of a rise in the price of assigned amount units. If the demand for assigned amount units is much larger than the supply, energy saving could be expected for the mid to the long term, but not for the short term.

<sup>3</sup> Here the issue of supplementarity is not specifically considered. Also, a case in which the Party *intentionally* does not purchase permits (for instance because it is expensive) is not supposed.

<sup>4</sup> This committee will conduct the same kind of estimation methodologies as a private *ranking institution* does in case of determining buyer liability.

<sup>5</sup> There are several ideas for setting the price of these special permits. Here the example of the standard is a doubling of the highest expected marginal cost of emission reductions in the Annex I region.

merit *not* to “punish” a sovereign nation, although its effect is equivalent to the penalty procedure. The country concerned can comply with the Protocol by purchasing the permits but has to face a high interest.

5. In case a Party neglects to purchase such fixed, high rate permits, some other procedures are needed. Whatever decision is to be taken then, it is clear that a balance should be found between the aim to keep the Party within the Protocol and the strictness that is required to encourage the Party to comply with its commitments.

#### **4 Participation of Developing Country Parties**

Several observers have argued that the future participation of the non-Annex I Parties in a global GHG abatement policy is crucial for achieving the objectives of the FCCC. The key question, thereby, is how to design a scheme of co-operation that encourages developing countries to participate in a global policy. Below, we present two possible forms of co-operation.

The first possibility is based on the idea that some high-income developing countries could join the group of Annex I Parties. The criteria for this could be, for example, a certain level of per capita GDP and/or OECD membership. Although this issue has turned out to be a very sensitive one, we would expect that in the future some *automatic* graduation scheme will be introduced.<sup>6</sup> In such a scheme a non-Annex I Party can voluntarily join the QELRC regime (and use the flexibility mechanisms) as an Annex B (or maybe Annex C) Party. The former Article 10 of the Chairman’s text that was deleted during in the negotiation process at COP 3 had this opt-in clause. Some non-Annex B Parties expressed themselves in favour of this participation recognising the merits of international emissions trading.

Designing a proper formula for the initial allocation—assigned amount or quantified commitment—for this opt-in participation seems to be a key element: will it be an absolute level (for example, per capita) or a *growth target* on the basis of baseline? Below, we propose

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<sup>6</sup> Some ideas for criteria are already envisaged, such as exceeding a certain level of per capita GDP or three years of OECD membership.

some possible formula which could enable a non-Annex B Party to choose a voluntarily commitment:

- a per capita emissions *level* (e.g., 0.7 tC eq. per capita per annum), or a
- decreasing *rate* of the GHG emissions intensity against GDP (e.g., 0.5% per annum).

It would be better to admit the non-Annex I Party to choose one formula from a set of different types of commitments such as the *absolute level* formula and a decreasing *rate of change* in order to reflect each country's characteristics. It is our expectation that relatively loose targets in this respect might result in higher longer-term environmental benefits.<sup>7</sup>

## 5 Viewpoints from the Market

It has been argued several times that for a full utilisation of the global low cost options for GHG abatement an efficient and well-functioning GHG trading market is indispensable. The market must be transparent, autonomous, liquid, and stable (with some appropriate fluctuations) in order to fulfil these conditions. Here we consider some related points to this matter.

At this stage, the Chicago Board of Trade (CBOT), the International Petroleum Exchange (IPE) and the Sydney Futures Exchange (SFE) have expressed their intentions to be the commodity exchangers of the GHG permits. In addition, secondary markets could emerge utilising these Exchanges, and developing standardised derivatives which can offer much more liquidity to the market. World-wide 24-hours market with plural Exchanges would be preferable. In an ethical sense, sales by speculation may be questionable, but speculators are needed because they function as risk-takers and enable the energy consuming companies to hedge their risks. Regarding defaults it does not seem to be necessary to use a special treatment as ordinary business contract could well be used for this.

Information like the market price of the permits, GHG emissions/energy consumption trends,

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<sup>7</sup> Examples of longer term benefits are: opt-in might be linked to the timing of entry into force of the Protocol, early establishment of monitoring system in the developing countries, setting a *cap* including the developing countries, incorporating early reduction incentives for developing countries, reducing the risk of market manipulation by some big CEE countries and realizing the fluid emissions market by inviting many more suppliers. We can also expect the effect of a correction of the South-North gap through the income transfer.

*etc.* may be supplied by the Exchange and/or brokers as is often the case with other commodities. This could mainly be done through the Internet, under the supervision of the central administrative body. If buyer's liability is installed, a ranking of companies may play a very important role in providing information.<sup>8</sup>

It may be remarked here that trading deals between governments (for example, the formation of a "bubble" in the case of the EU) does not necessarily have to imply a market distortion. However, trade barriers between the bubble group on the one hand and non-bubble members on the other hand may impede a sound market functioning and conflict with the WTO rules.

The credits which result from CDM or JI projects should be equally valued as the permits under IET ("a ton is a ton").<sup>9</sup> In addition, it could also be remarked that the project-based CDM and JI regimes may send price signals to the IET "market." Especially, the CDM can play an important role because of the possibility to already start with crediting CDM projects as of 2000. The results of CDM projects may provide useful information to estimate the price of JI credits and IET permits before the JI and IET regimes start.

## **6        Supplementarity**

What kind of guidelines are sufficient to meet the clause in the Kyoto Protocol focusing on "domestic policies and measures" without setting ceilings for using flexibility mechanisms?<sup>10</sup> Here we propose the idea to initiate a program to develop some standards such as *common physical performance indicators* (intensities like electricity generating efficiency, fuel efficiency, *etc.*). This idea is based on the spirit of Article 2 of the Protocol. The CoP/MoP could recommend Parties to achieve such standards (*without* setting mandatory standards).

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<sup>8</sup> The author prefers "seller's liability" system. The market might not function properly in the initial stage of its implementation, especially for the buyer's liability case because of the hesitation to participate in more risky market..

<sup>9</sup> We must recognize that ERUs have the attribute of some buyer's liability. This may cause some operational differences with CERs and/or tradable permits under IET.

<sup>10</sup> Some idea to set ceiling to the (net) GHGs emissions trading have been proposed by the EU and others, but no concrete and in-depth analyses is provided yet with its level, method, *etc.* For example, a situation can be envisaged that early (private) deals turn out to be invalid because the Party has surpass its ceiling. Some concrete ideas to correct these issues could be considered, but they are rather arbitrary.

The Secretariat could compile a matrix table of such indicators, evaluate them on a country-by-country basis and make it open to the public. Through this process, policy-makers of each Party can recognise concretely its weak region/sectors in terms of energy-saving performances.