What Should the US Learn from the EU ETS?

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Evaluation from a Different Perspective

- Not concerned with ETS Review, or how to improve the existing system
  - Depends a lot on specific EU circumstances
  - In fact, a multinational system
- Serious debate on C&T beginning in the US
  - Surprising amount of attention to EU ETS
- What does the EU ETS teach the US (or others) to do and not to do?
Lesson #1: A carbon price won’t “wreck” the economy

- An exaggerated argument, but effective
- The EU economy has thrived and even equaled (!) US performance since 2005
- Could dodgy US sub-prime mortgages have more effect than a CO₂ price?
- Good EU economic performance also not due to the carbon price; just one of many
- At last, a quiet and compelling example from Europe
Lesson #2: Adopt a long horizon with banking and borrowing

- Repeated, sequential trading period is largest defect in EU ETS
  - Disincentive to investment or a politically helpful ambiguity?
- Alternative is long-horizon, pre-specified caps with review
  - Difference is in the presumption
- No evidence of abuse of borrowing in ETS
  - A radical innovation in emissions trading
Lesson #3: A Safety Valve May be Warranted!

• Initial prices can exceed expectations
  – Seen also in US OTC/NOx Budget Program
  – In both cases, due to regulatory uncertainty, inexperience, and institutional features

• Perhaps a transitional, phase-in feature?
  – Motivation more political than economic
  – Lack of confidence/experience in GHG abatement

• Can long horizons and borrowing be a substitute?
Lesson #4: Make sure installation-level data is available

- A big problem in ETS NAP1 exercise
- Free allocation to incumbents assumes good installation-level data
  - All existing systems have high initial levels of free allocation
- Good cap-setting also assumes good data on covered sectors
  - Probably bigger problem in NAP1
Lesson #5: Upstream MRV for small sources

- **EU ETS uses an upstream MRV method applied downstream**
  - It works, but high transaction cost for small sources
  - Also justifies less rigorous MRV “tier”
- **If EU ETS expands coverage, it will be forced to upstream MRV**
- **For US system with transport or res/com sectors, go upstream from start**
Some More Problematic Lessons?

- New entrant and closure provisions
  - Ubiquitous in EU ETS but rare in US
  - But present in Bingaman & Lieberman bills

- BTA provisions
  - Presumption of “deep then broad” or simply an option (that may not be used)?

- Auction/free allocation split and evolution
  - High initial & phased-out free allocation observed in principle and practice in EU
  - But much higher initial level than proposed in US
More generally...

- It works
- It is not a big thing economically, and
- It can’t be ignored in thinking about global architecture
  - A fact on the ground diplomatically
  - The “motor” of the world carbon market
  - Engaging China & India in a global trading regime