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 CO_2 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