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# The Importance of a Clearly Defined Policy Goal for AAU Trading

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International Emission Trading (IET) has been a key element of the cost-containing flexible mechanisms of the Kyoto Protocol and could prove to be a useful tool in the future. However, trading of AAUs from countries whose emissions have declined since their baseline year under the Kyoto Protocol has led critics to be skeptical of carbon markets due to the lack of actual emission reductions that occur as a result of these trades.

The overall size of the AAU market is staggering. Altogether, the former Soviet Union countries and Eastern Europe have emissions that are 35% below 1990 levels,[i] leaving approximately 13 Gt CO2 of surplus metric tons of carbon dioxide equivalence to sell.[ii] The baseline year of 1990 was selected for most countries except those in the process of transitioning to a market economy. These transitioning countries were able to choose their baseline year.[iii] The year 1990 was particularly advantageous to parts of Eastern Europe and Russia, which had a heavy industrial year in 1990 before the Soviet Union dissolved completely in 1991. Given the recent economic downturn, the 13 billion surplus AAUs could fulfill all required commitments by 2012, and the market would still be oversupplied by 9 billion AAUs. And, assuming that countries take on the targets they have discussed in negotiations, this surplus could fill reduction targets until 2020, and there would still be 6.9 billion excess AAUs.[iv]

Green Investment Schemes (GISs) are meant to try to allay the fears of those that think there is no environmental integrity in AAU trading by using the proceeds of AAU trades to create projects that absorb or reduce greenhouse gases. However, these GISs have no required criteria for crediting and actual determination of what qualifies as a GIS is left up to the discretion of the buying and selling countries. Inconsistent application of GISs as AAU trades ramp up toward 2012 when the Kyoto Protocol ends and post-2012 during the next global greenhouse gas accord could erode the price of emission reductions and allowances worldwide and may elicit a harsh rebuke from those concerned with reductions in current emissions.

The wide-ranging results of AAU trades include the promotion of projects that encourage emission reductions but do not ensure them on a one-to-one basis; creation of projects that attempt to yield an emission reduction for each AAU sold; and satisfaction of Kyoto targets with below-market priced permits to pollute that do not represent any emission reductions. Policy makers need to clearly define the goal of AAU trading as 1) a way to address current carbon market failures through promotion of "soft" greening projects; 2) a means to promote investment in a selling country; 3) a trade that must be accompanied by a one-to-one emission reduction project; *or* 4) a scheme to promote cost containment in the next global agreement and create an accord that effectively achieves the goal selected.

If the goal of IET post-2012 remains to provide Annex B countries with a means "of fulfilling their commitments," then perhaps no changes to the way the AAUs are traded, baseline years chosen, and future targets should be required. The Swiss firm Interblue took advantage of cheap AAUs in a purchase of 15 million AAUs from Slovakia for the price of €5.05, half market value.[v] There was no GIS to back up this AAU trade, and the price reflected it. If a "hard" greening GIS project that resulted in emission reductions on a one-to-one basis with AAUs sold was required, the price of the AAUs would have certainly been higher. This purely market-driven cost containment measure will produce revenues for EIT and help reduce the cost of compliance, perhaps at the risk of not achieving sufficient greenhouse gas reduction.

The Intergovernmental Panel on Climate Change, which assesses the scientific, technical and socio-economic information relevant for the understanding of the risk of human-induced climate change, has determined that emission cuts of 25-40% below 1990 levels are necessary in order to prevent catastrophic climate change and experience 2 degrees of warming by 2100. Inclusion of excess AAUs into existing and future global frameworks for reductions would mean that Annex I countries would only cut emissions between 5-13%.[vi]

If the goal of IET is to address the market failures of the Kyoto Protocol and replace or complement Nationally Appropriate Mitigation Actions, then perhaps GISs that provide "soft" greening GIS projects that support sectors that cannot be traditionally supported by CDM or JI due to strict additionality and monitoring and verification requirements. It is typically not possible to monitor the emission reductions from "soft" GIS projects in a precise way, but these projects represent important steps towards reducing a country's greenhouse gases."Soft" GISs are

meant to support greenhouse gas reduction activities that take the form of energy efficiency programs, loan guarantees for projects that absorb or reduce emissions, or customer incentives to engage in activities that use less greenhouse gases.

If the goal of IET is to stimulate investment in a country and ensure that emission reductions are created for each AAU sold, then only GISs that include "hard" green projects that produce a one-to-one relationship of emission reductions created per AAU sold should be allowed and a standardized way of evaluating and monitoring these projects should be created.Examples of "hard" greening projects supported by Estonia include improvement of district heating networks, boiler house rehabilitation, industrial energy efficiency, and public transportation projects.[vii]

Countries have not been consistent with the type of greening scheme that is accepted by their country. The Ukraine is now considering soft greening schemes whereas the country previously stated that it would only accept "hard" greened projects. Hungary has stated that it supports only "hard" greened projects, but it recently stated that it may use AAUs for a budget crisis instead of emission reduction projects.[viii] Poland, Romania, Slovakia, Bulgaria, Lithuania, and Russia have not finished setting up systems to administer GISs.[ix]

Apart from the argument that AAU trades should have a GIS for environmental reasons, there is an economic argument for GISs to back up these exchanges. AAU trades that are not backed by a green activity have the ability to erode the price of carbon towards the end of the Kyoto compliance period. If a project is not required to produce any environmental benefit, then the opportunity for trades well below market price, which is set by the cost of making a metric ton of reduction elsewhere in the world, will abound. And, some market critics have claimed that only "hard" greening projects should be accepted since "soft" GISs could still cost less than other compliance instruments since there is not attempt to monitor and verify the emission reductions created.

Deciding on the purpose of AAU trades in future greenhouse gas markets will help market designers to also make decisions about how to best control the impact that the surplus AAUs will have on the price of future compliance instruments and the environmental effectiveness of this legislation. To control the impact that surplus AAUs would have on future greenhouse gas markets, market designers could mandate that AAUs 1) always accompany "hard" or "soft" GISs; 2) be allowed for banking into the future compliance period; 2) not be allowed at all for use after 2012; 3) be allowed for only domestic emission reduction goals after 2012; or 4) be allowed for limited trades.[x] The scenario selected will be determined in part by the overall policy goal for AAU trades in a future framework.

It is essential that a decision on the status of surplus AAUs for a post-Kyoto framework be made quickly as it will have implications on the 2011 and 2012 price of carbon as countries with surplus AAUs move to either sell them on the market or hold them for future compliance periods. In the absence of a decision, countries with AAUs to sell may take advantage of the lack of regulation on GISs and simply dump AAUs with no environmental backing on the market. In the process of making the Kyoto Protocol palatable to all countries by providing a high degree of sovereignty to countries in their implementation of rules to support AAU trades, market designers have created the risk of undermining the entire market.

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[i] "Industrialised countries will collectively meet 2010 Kyoto target," Netherlands Environmental Assessment Agency, date?

[ii] "Too hot to handle?The emission surplus in the Copenhagen negotiations," M.G.J. den Elzen, M. Roelfsema, S. Singerland, Netherlands Environmental Assessment Agency, December 2009.

[iii] "Kyoto Protocol Base Year Data," United Nations Framework Convention on Climate Change webpage, http://unfccc.int/ghg_data/kp_data_unfccc/base_year_data/items/4354.php

[iv] "Assigned Amount Unit: Seller/buyer analysis and impact on post-2012 climate regime," Point Carbon report for CAN Europe, October 26, 2009.

[v] "Working Paper Green Investment Schemes: First experiences and lessons learned," Andreas Tuerk, et al. Joanneum Research and Center for Climate Change and Sustainable Energy Policy of the Central European University, April 2010.

[vi] "Too hot to handle?The emission surplus in the Copenhagen negotiations," M.G.J. den Elzen, M. Roelfsema, S. Singerland, Netherlands Environmental Assessment Agency, December 2009.

[vii] "Working Paper Green Investment Schemes: First experiences and lessons learned," Andreas Tuerk, et al. Joanneum Research and Center for Climate Change and Sustainable Energy Policy of the Central European University, April 2010.

[viii] "Governments keep hunting for cheap CO2 credits," Michael Szabo, Reuters, March 3, 2009 and "Working Paper Green Investment Schemes: First experiences and lessons learned," Andreas Tuerk, et al. Joanneum Research and Center for Climate Change and Sustainable Energy Policy of the Central European University, April 2010.

[ix] "Working Paper Green Investment Schemes: First experiences and lessons learned," Andreas Tuerk, et al. Joanneum Research and Center for Climate Change and Sustainable Energy Policy of the Central European University, April 2010.

[x] "Assigned Amount Unit: Seller/buyer analysis and impact on post-2012 climate regime," Point Carbon report for CAN Europe, October 26, 2009.