

“Cap-and-Trade” Allocation

- Key principles
- Who to ?
- When ?
- How ?

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Key Principles of an Emissions Trading System

- Absolute caps – i.e. **not** based on CO₂ per unit of production.
- The point of regulation (allocation) is set by the "make-or-buy" principle. This means that the holder of allowances should be both the emitter and (even more importantly) the party that can initiate the projects that create the reductions.
- Allowance allocation (supply) should stretch at least 10+ years.
- Allowances granted free (grandfathering) at the start.
- Longer term, allocation should not withdraw capital from the firms and industries covered by the scheme, nor should it grant windfall profits.
- Allocation design and any use of auctioning should consider the ability of the sector to pass through costs to the consumer.
- Not be subject to constraints that may limit or artificially skew the supply or demand of allowances (e.g. a price cap or floor, a limit on the use of project offset mechanisms).
- Stand-alone - not bolstered with additional mandated requirements (e.g. BAT).
- Recognises key abatement technologies - CCS.
- Recognises the existing international project mechanism (CDM).

Many of the key design principles are related to allocation



Who to allocate to ?

The point of regulation (allocation) is set by the "make-or-buy" principle. This means that the holder of allowances should be both the emitter and (even more importantly) the party that can initiate the projects that create the reductions.

Why: Shifting the point of regulation (allocation) upstream breaks the financial connection between physical emissions and allowances, which means emissions can only be managed by reduced consumption of the energy product.



When to Allocate ?

- The market should know far in advance (15+ years) the number of allowances available in any future trading period (long-term goal).
- Individual facilities should know their allocation at least 5-10 years ahead of time.
- These steps encourage long-term investment decisions and help a forward price develop.
- Actual allocation (transfer to registries) should be several years ahead as this creates the commodity and enables forward trade.



How to Allocate - Key Principles

- The aim of an ETS is to direct capital towards low CO₂ emissions projects, via a market price for CO₂.
- The trading system should not withdraw that capital from the industries or firms covered by the system.
- Any such removal of capital would slow down the necessary investment in more CO₂ efficient technologies and projects to the detriment of the environment in the long term.
- Allowance allocation should not be considered as a revenue raising opportunity (i.e. buying the “right to pollute”) since an emission trading system is a not tax-based instrument, but aims to create an incentive to reduce emissions.
- Revenue raising also introduces a secondary allocation issue.



How to Allocate - Approaches

A measured approach over time:

- Allowances granted free (grandfathering) at the start based on historical emissions. This minimises disruption and allows a smooth transition for the capped sector.
- Benchmarking can play an important role in subsequent years.
- Longer term, allocation should not withdraw capital from the firms and industries covered by the scheme, nor should it grant windfall profits.
- Allocation design and any use of auctioning should consider the ability of the sector to pass through costs to the consumer.



