Keynote address
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OECD global forum on sustainable development: emissions trading
Concerted action for tradable emissions permits (CATEP): country forum

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It is my great pleasure to speak here today. This gathering is unique in bringing together two communities which sometimes have too little to do with each other. The politics of policy can hold apart the research and policy-making communities. For many researchers, the politics is to be abhorred for ruining many a good policy proposal. For many policy makers, policy sometimes has to please more than it has to work.

This joint forum of the OECD and the CATEP network comes at a moment when emissions trading is taking on a role in climate policy that, for a while, many of us thought it would not reach. The recent progress by the European Union towards finalizing its trading directive restores confidence that policies favoured by researchers for their efficiency can also be implemented by policy makers. This scheme will form by far the largest single international market under Kyoto. But initiatives at the domestic level, including in the US, also indicate that **trading's time has come**.

This implementation phase of emissions trading, and of joint implementation projects, will also provide an opportunity to involve Russia. We are of course awaiting only Russia's ratification for the Protocol to enter in force. In this context, a decision by the EU to allow linking to other Parties' trading systems must be a good signal to add to the many positive signals from the Russian side that ratification may occur soon.

Few people participating in the negotiations on the Kyoto Protocol will have foreseen the degree to which **Europe** would take up emissions trading. Implementation now lies less than two years away for an estimated four to five thousand installations expected to cover almost half of the region's CO_2 emissions in 2010. With the involvement of up to 28 countries, it will provide access to a vast range of emission reduction opportunities.

The architecture of the EU scheme is clear and simple and appears to be generally acceptable to the industrial players who will be at its core. It is backed by a strong compliance framework. It is open to being linked with trading systems outside Europe. Emission reductions from Kyoto's clean development mechanism and joint implementation projects are also to be integrated. I am not suggesting that the EU scheme is perfect. But it is important to make a **robust start** in flexible instruments that can reduce the cost of meeting our climate goals. Over time, the scheme may be

expanded to include more activities and more gases. There is little doubt that the EU scheme will become a key driver for emissions trading schemes all over the world.

Outside the EU, Norway may well implement the EU trading directive while other countries, such as Canada, Japan, New Zealand and Switzerland, remain open to the option of installing trading schemes. In the US, the original home of emissions trading, many trading initiatives are being made, from state-level initiatives such as that in New Hampshire to the federal level McCain-Lieberman Bill.

The early movers in **industry** have without doubt contributed greatly to the favour that trading now enjoys. Industry has been showing the way for years, with the internal schemes of companies such as Shell and BP, pilot projects such as those with the government in Canada, the activities of all those trading pioneers of the carbon market and, more recently, initiatives such as the Chicago Climate Exchange. But industry-led schemes are subject to natural limits; the role of governments is clear in setting legal frameworks and targets. The EU experience shows that the implementation of mandatory, across-the-board trading schemes can ease issues of competitiveness among companies within a region and may ultimately be more likely to result in overall industry acceptance.

But action at the national level is also being backed by **intergovernmental activities**. COP7 in Marrakesh was a major milestone in laying down most of the rules for the workings of the Kyoto Protocol and in opening the way to the rush of ratifications that we have seen over the last year. COP8 in New Delhi was also instrumental in clarifying remaining details of this rulebook.

These rules set out requirements to be met by **national registries** in Annex I Parties, as well as the CDM registry to be established for non-Annex I Parties by the CDM Executive Board. Many governments are at work to set up their national registries as early as 2005. Work is also underway in the secretariat to develop and operationalize the **transaction log** by the end of 2004. This log will form a cornerstone in the trading system under the Protocol by monitoring the system's overall integrity. Work is also underway in the secretariat to further elaborate, by the end of this year, the **data exchange standards** adopted in New Delhi to ensure the compatible electronic communication between registries that is required to enact transactions.

The Executive Board of the CDM has been working hard since Marrakesh to prepare the **prompt start of the CDM**. This has included clarifying the methodologies that will be acceptable for calculating emission reductions. Simplified rules have been established to reduce transaction costs for small-scale projects. The Board has now almost completed putting in place the systems for it to register the first CDM projects and for their emission reductions to be verified. We could well see the first CERs generated by CDM projects before the year is over.

The Board has the task not only of putting in place systems that will facilitate project implementation, but also of safeguarding the environmental integrity of the CDM. Striking the right balance is a challenging assignment and I feel that the Board is doing an admirable job.

Once issued, these CERs will be the first units brought into existence under the Kyoto Protocol. The rulebook from Marrakesh clearly states that **CERs are to be tradable** under the Protocol and the flexibility and added market liquidity this will bring can be expected to expand the range of available abatement opportunities and reduce the overall costs of reducing emissions. This, of course, is in addition to the CDM's potential to help non-Annex I Parties shift towards a path of sustainable development and enhance their contribution to addressing climate change.

What we have yet to see is how this vision of flexibility and integration, as taken up by the Protocol, will be translated into trading markets on the ground. The freedom, under the Protocol's open trading framework, to implement policy instruments of a Party's choosing presents scope for both synergies and conflicts. Differences in architecture can lead to incompatibilities that may prevent the linking of trading schemes and the recognition of credits arising from the CDM and JI. Also, while some Parties may wish to differentiate between projects and sellers, care should be taken so as not to introduce undue restrictions on the market.

At present, it is not possible to speak of a single market for trading or for projects relating to climate change. What we have instead is a series of largely unconnected markets: corporate trading schemes, credit trading among industry players, domestic trading in the UK and a few other countries, a proposed EU scheme and, of course, emissions trading under Kyoto's Article 17. For the sake of effective climate change action, I hope this will change. The new government-led trading schemes, and the successful integration of the CDM and JI into domestic trading, must help consolidate markets and must contribute to their maturity and efficiency.

Of course, much implementation and linking work still remains. Many governments have still to determine the elements of their **domestic mitigation policies**, both relating to trading and other elements of their policy packages. On the international front, it is also important that governments develop **strategies** for how they wish to use the mechanisms under the Kyoto Protocol – and how their entities may be involved. Furthermore, **institutional capacity** urgently needs to be built within governments and the private sector. Parties will need to meet the eligibility requirements to participate in the Kyoto mechanisms. They, together with private sector actors, will need to conduct day-to-day activities related to the mechanisms. Of one thing I am sure: as we go, we will be "learning by doing".

On balance, I think that we are moving ahead and in the right direction.

I wish now to turn in particular to one of the communities present here. As a policy-person, and despite the political issues that sometimes limit us, I am on the side of the fence that looks to the researchers to discover how best to implement policy. There has been much good work in recent years on trading *design* and this has been invaluable in bringing us to where we are presently. But I believe the **real research challenge** for trading is now found in how best to *implement* the trading policies that are on the table before us. Meeting this challenge would be a great service to policy makers as they grapple with immediate implementation problems that still remain.

There are three areas of implementation-related research that I would like to highlight today.

1. Firstly, I imagine that it would be very useful to develop a **methodological framework** for allocating obligations to emitters. The EU trading scheme, for example, requires the development by Member States of allocation plans by which allowances are to be distributed free of charge. We already have considerable literature on different approaches to this issue but we need now to apply this to the specific challenge at hand. Empirical studies and simulations of different allocations can help in assessing the implications for many issues, such as allowance prices, industry output and competitiveness, profitability, and technology innovation. This type of research would help policy makers enormously in more clearly assessing how costs would be distributed among trading participants.

   I believe that allocation is the hardest of the trading issues facing governments. Of course, it is a very political issue. But this is all the more reason for developing a technical basis to inform decision-making in this area.

2. Secondly, it would be very useful to research the implementation, *in parallel*, of **multiple trading regimes** in one country or region. Policy makers will have to come to terms with implementing schemes at the Kyoto level as well as at the regional or domestic levels, if not all three together. These different types of trading may apply to mutually exclusive sectors, or they may overlap, with participants being involved in several schemes simultaneously.

   Recent work on linking trading schemes would surely be of relevance here, including issues such as different compliance penalties, different monitoring and verification procedures, and absolute versus relative targets. In addition, trading schemes may integrate project credits from the CDM and JI differently, leading to non-uniform implications for prices.

   A further dimension of parallel trading is the use of trading to control other pollutants, such as oxides of sulphur and nitrogen (SO_X and NO_X), as is being considered or implemented in several countries. Though the targets and allowance allocations for one pollutant would affect the cost-effectiveness of measures to reduce another, virtually no research has been undertaken on subjecting sources to multiple pollutant trading.

   The idea of multiple, parallel trading schemes is one variant of how trading may be implemented in tandem with any other type of policy instrument, whether it be for climate change or other purposes. It is also only one example of how more consideration needs to be given to the particular conditions under which different mixes of instruments will usefully exploit synergies than cannot be targeted through one instrument on its own. This is, of course, the bread and butter of the OECD, and well reflected in its current Environment Programme.

3. A third implementation issue worthy of research seems to be how the **transition** might be made from existing policies to trading regimes. Many countries wish to continue with voluntary agreements with industry but recognize that it may be necessary at a later stage to make a switch to a trading regime. Europe is facing this issue sooner in its implementation of EU trading. This may also be an issue for JI projects in the EU accession countries if these installations are later to be subject to EU trading.

I am of course not a researcher. For that matter I am also not someone who implements policies. But, as my policy-making colleagues shift into implementation mode, their world is becoming vastly more detailed and considerably more complex. These seem to me to be some key issues on which research would greatly help. The CATEP network, as well as my friends at the OECD, are very well-placed to contribute to filling these and other gaps in our current knowledge.

I wish you every success in the next two days as you reflect on trading's research-policy interface and seek useful work directions for the future.