

An Institutional Framework for the Global Carbon Market : Options and Implications

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Overview of Presentation

1. Moving towards a Global Carbon Market
2. Role and Mandate of an Institutional Framework
3. Lessons from Governance Theory and Practice

Moving towards a Global Carbon Market: An Evolutionary Process

Slide 1: Pathways to a Global Carbon Market

Slides 2 & 3: WTO and Bretton Woods – A Model?

Pathways to a Global Carbon Market

- **1st Phase:** Emergence of GHG emissions trading at the national/subnational level; early markets are immature, limited in market size, with low liquidity and high volatility
- **2nd Phase:** Some national schemes converge, regional schemes emerge; generally larger market size, greater maturity, rise of a professional services sector; yet globally, markets still fragmented
- **3rd Phase:** Cooperation across schemes emerges, informal exchange on information and practices; unilateral and indirect linking widespread; discussions about bi- and multilateral linking
- **4th Phase:** Formal bi- and multilateral linking expands, “umbrella agreements” on cooperation to manage the emerging market
- **5th Phase:** Global carbon market with multilateral participation, governed under an overarching institutional framework?

WTO and Bretton Woods – A Model? (I)

Evolution of international trade in goods

- **1st Phase:** Local and regional trade in goods
- **2nd Phase:** Trade between nations emerges with ad-hoc arrangements, eventually developing into a network of fragmented bilateral trade agreements
- **3rd Phase:** Regional trade blocks are formed, plurilateral trade agreements emerge
- **4th Phase:** Liberalization of international trade under a formal multilateral agreement (GATT)
- **5th Phase:** Comprehensive liberalization regime for international trade in goods, services and rights under an overarching institutional framework (WTO)

WTO and Bretton Woods – A Model? (II)

Evolution of international monetary system

- **1st Phase:** Local, regional and national currencies emerge
- **2nd Phase:** Currencies recognized across jurisdictions, not only due to inherent value of tender, but also guarantee by issuer
- **3rd Phase:** Monetary systems converge through pegging to precious metals (19th century: silver; 1870: gold standard)
- **4th Phase:** Bretton-Woods system (1944): Gold-Exchange Standard with fixed exchange rates and reserve currency (US\$)
- **5th Phase:** Gold-Exchange Standard collapses (1973), new system of floating exchange rates; international institution (IMF) charged with providing order, stability and liquidity in international currency markets, preventing foreign exchange restrictions and competitive currency depreciation, and banking currencies

Role and Mandate of an Institutional Framework

Slide 1: Why an Institutional Framework?

Slide 2: Scope and Purpose: Defining a “Mandate”

Slides 3 & 4: Legal and Administrative Implications

Why an Institutional Framework?

- Carbon trading increasingly sophisticated, with transactions not only by regulated entities, but also by financial intermediaries; compliance trading may eventually be surpassed by speculative trading and trade in derivatives
- Economic and financial crises highlight importance of regulatory oversight and ‘good governance’ of markets; emerging discussion on appropriate bodies for domestic carbon market oversight and supervision

Example: Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC) or newly appointed body (e.g. Lieberman/Warner: Carbon Market Efficiency Board) in the United States

- Barring coordination, international carbon market likely to develop in a geographically diverse, fragmented and heterogeneous manner with horizontal administration

Scope and Purpose: Defining a “Mandate”

A carbon market institution might:

- collect data, improve transparency and recommend practices
- prevent market speculation and manipulation (fraud, unfair competition) as well as gaming of regulatory loopholes
- ensure the environmental integrity of the market by overseeing the stringency of domestic caps, admissibility of cost containment options and reliability of monitoring and enforcement arrangements
- manage carbon prices to avoid an unwarranted cost burden, short term volatility or weak price signals, e.g. by defining price corridors
- control unit reserves and limitations on banking, borrowing or offsetting, and participate in the process of allocating or auctioning units or even oversee and coordinate revenue expenditure

(Source: Tuerk/Mehling/Flachsland/Sterk, 2009)

Legal and Administrative Implications (I)

Legal Options for an Institutional Framework

- Organizational “charter” or “establishing treaty”: binding international treaty between participating jurisdictions
- Defines objectives and responsibilities, and outlines powers conferred by contracting parties (“Member States”)
- Specifies governance structures and procedures, such as creation of a governing body (appointed representatives with specified terms and conditions of appointment, and with rules on geographical and professional diversity) and standardization or rule-making powers (voting procedures)
- May also define accountability and dispute settlement procedures and rules

Legal and Administrative Implications (II)

Carbon: Commodity or Currency?

- Discussion could regain relevance for question of suitable institutional arrangements and carbon market governance
- Commodity would suggest model more akin to WTO, currency would suggest model more similar to IMF
Similar debate in domestic context, e.g. in the U.S.: CFTC v. SEC
- Many similarities with commodity (spot trading, large quantities), **yet:** value of carbon units entirely dependent on their recognition for compliance and not on intrinsic properties, value of unit (e.g. one ton of CO_{2e}) different in different jurisdictions, and borrowing possible
- International Financial Reporting Interpretations Committee (IFRIC) of the International Accounting Standards Board (IASB): *akin to currency!*
Currency model yields experience with floating currencies (reporting and reviewing exchange rates) and pegged currencies (defined standard, reserve currency), providing emergency supply through lending to ensure stability and liquidity (e.g. IMF system of 'Special Drawing Rights', or SDRs), and integration of currencies in monetary unions subject to defined stability criteria (e.g. EU Economic and Monetary Union, or EMU)

Lessons from Governance Theory and Practice

Slide 1: Guiding Principles and Considerations

Slide 2: Lessons from the Clean Development Mechanism

Guiding Principles and Considerations

Experience with domestic exercise of political authority and use of institutional resources suggests need to ensure:

- due process, procedural fairness and participatory rights as preconditions of legitimacy and thus sustained compliance
- formalization of powers and procedures, with specified privileges, immunities and accountability of empowered officials
- precision of rules, reasoned decisions and expertise to safeguard predictability and transparency, thereby instilling confidence in market participants and other affected stakeholders
- *possibly*: review and dispute settlement mechanisms to secure equitability of substantive decisions and outcomes
- *possibly*: definition of conflict of interest clauses and creation of ‘ombudsman’ to help avoid corruption and abuse of power

Lessons from the Clean Development Mechanism

Current Challenges with CDM Governance

- very constrained right to be heard by the Executive Board (EB) in terms of legal standing and right to appeal
- lacking sovereign immunity of EB members renders them subject to individual liability and affects their decisions
- no reasonable notice of proceedings and consideration of their impact on decisions
- lacking consistency of decision making and of uniformly applied processes undermines confidence of participants
- insufficient provisions on disclosure, transparency, predictability, and retroactivity of decisions
- concern about bias of decision makers and capricious decisions

Thank You!

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