

BUSINESSES FOR CLIMATE PLATFORM

Lessons Learned from an Emissions Trading System Simulation in Brazil

A Corporate View and Proposals

Overview - November/2016

Prepared by **Businesses for Climate Platform**:



The Center for Sustainability Studies (GVces) of the School of Business Administration at Getulio Vargas Foundation (FGV-EAESP) has, since 2013, simulated an **Emissions Trading System** with Brazilian companies, called the **EPC ETS**. This market simulation is part of the Businesses for Climate Platform (EPC), an initiative which intends to raise awareness for and engage business leaders about the management and reduction of greenhouse gas emissions and climate related risks, as well as proposing public policies for a low carbon economy.

EPC ETS aims to engage Brazilian companies in the debate and promote learning about suitable approaches for a comprehensive carbon market in Brazil, as well as co-creating, with the companies, clear proposals for the government about a possible market in the country, highlighting businesses perceptions and proposals (on the matter).

The proposals contained here intend to support government decisions in case an emissions trading system gets adopted. As such, no assessments are offered on the relevance or applicability of an ETS in Brazil, or any other pricing mechanisms. Only general and structural recommendations for a market are made, with the purpose of helping to design such an instrument, should an ETS be established in the country.

The Proposals for an Emissions Trading System in Brazil were formulated based on the knowledge acquired by member companies throughout EPC ETS' building and implementing processes in 2013, and during its three years of operation (2014-2016). They were also based on existing ETSs, such as California's Cap and Trade Program and the European Union Emissions Trading System (EU ETS). Additionally, previous studies carried out by GVces for Brazil's Ministry of Finance represented fundamental stepping stones for an initial understanding of the technical features of an emissions trading system.

The Proposals presented in this document were built in conjunction with EPC ETS member companies, who shared not only their learnings from three years of participation in the market simulation, but also their views and perceptions on the subject. It is of great importance that government initiatives on carbon pricing are shared with society from their conception, so that the adopted mechanism might have wide acceptance and counts on the commitment of the actors involved.

General recommendations for an ETS in Brazil

These general recommendations seek to strengthen the understanding that emissions trading systems are embedded in broader contexts, nationally as well as internationally. They therefore highlight some aspects associated with broader issues, which should also be considered during the planning and implementation of an ETS.

It is recommended that:

Assessments of the objectives and scope of the ETS consider its effects on issues of competitiveness of exposed actors. An important measure for the protection of competitiveness of Brazilian companies could be the (additional) free distribution of permits for sectors more exposed to competition from international markets.

Decisions on sectors and activities covered by the market take into account the **costs and benefits** of including emitting sources in the ETS, and are based on **regulatory impact analysis**.

The reduction target set for the group of actors regulated via the ETS be **stringent enough so as to guarantee a significant contribution to the achievement of national mitigation commitments**. This implies adjustment provisions for maintaining the cap's stringency.

An ETS of national scope be designed so as to allow, at a later stage in its implementation, **possible links with trading systems of other countries**.

An ETS pilot is created **before the start of a mandatory ETS** for the training and engagement of actors involved.

All and any mitigation policy instruments be supported by **robust, transparent, and constantly updated information systems**. This particularly applies to carbon pricing instruments such as an ETS.

Proposal for structural elements

Proposals for seven structural elements are presented for the operationalization of an ETS in Brazil: MRV systems, compliance and enforcement, coverage, emissions limit (cap), allocation of permits, mechanisms of stabilization and flexibility and stakeholders engagement.

MRV System

- Creation of a **national emissions reporting program, with bottom-up features** that provides guidelines and sets standard procedures for monitoring, reporting, and verification of disaggregated information at the smallest organizational level possible (per business unit or plant/installation).
- National emissions reporting program featuring a database of standard (GHG) emission factors, to be used by regulated actors in the quantification of their emissions, leaving to companies the possibility of demonstrating greater carbon efficiency.
- Creation of an **emissions reporting program prior to the start of the ETS**, with sufficient time to obtain data about sources of emissions that allow the regulating agent to make informed decisions about structural elements of the market.
- Prior to the creation of a national emissions reporting program, **consideration of similar functioning state-wide information systems**, so to promote alignment between the national system and existing systems.

Compliance and Enforcement

- Establishment of procedures and mechanisms to facilitate, promote and enforce compliance to achieve the ETS objectives. However, they should be designed so as to not unduly impair the competitiveness of punished actors.

Coverage

- Definitions of sectors and activities to be included in a national ETS that **consider, among other aspects, the costs associated with the inclusion of a specific emissions source.**
- Coverage of sectors and activities that **include emissions' sources which are representative of Brazil's emissions profile**, as yet unregulated via other instruments or policies.
- Initial inclusion of activities and sources for which it is possible to require compliance with report guidelines and adequate auditing, **in order to ensure environmental integrity.**

Emission Limit (Cap)

- **Consultation or participation of regulated sectors** in the process of defining the cap in an ETS of national scope.
- **Initial adoption of an absolute cap**, due to a possible lack of information needed, and subsequent feasibility and desirability studies of adopting a relative cap.
- Calculation of ETS **reduction targets based on historical emission averages**, thus avoiding the use of a single base year for definition of the cap.
- Creation of a **reservation account**, as part of the cap, for allocating permits to

Proposal for structural elements

Allocation of Permits

- Allocation of permits via a **hybrid model: initial free allocation combined with periodic auctions**. Initially, most permits can be allocated for free, progressing to a higher allocation via auctions. The free allocation will help acceptance from society and can minimize the impact of regulation. On the other hand, auctions transfer the decision about the quantities necessary for settling emissions to those being regulated, which may favour a more efficient allocation.
- **Free allocation based on benchmarks, defined via intra-sectoral differentiation, based on levels of efficiency of each participant**, expressed in tCO₂e per unit of product. The adoption of intra-sectoral carbon intensity indicators (CIIs) makes it possible to compare companies within a sector or subsector, and allows for the consideration of the specifics inherent to each productive process when defining benchmarks
- **Setting a limit to the amount of permits a single participant may acquire through auction**, to prevent the unsubstantiated emergence of market-power among regulated actors.

Stakeholder Engagement

- Preparation and dissemination of a **Stakeholders Engagement Plan**. The involvement of stakeholders is key to provide acceptance and support for developing and implementing an emissions trading system.
- Conduction of **workshops, meetings, and training sessions** in which the emissions trading system guidelines are debated, agreed upon and, if necessary, revised.
- Creation of **feedback mechanisms**, such as online platforms and public consultations. Stakeholders must be encouraged to provide feedback and make proposals for adjustments to help improve the system, as well as provide the required information for assertive decision making on behalf of the system's governing body.

Mechanisms of Stabilisation and Flexibility

- Adoption of **mechanisms which aim to ensure a stable price range for market traded permits**, with the goal of offering a long term price signal.
- Establishment of **completion periods greater than a year**, which may contribute to reaching ETS objectives by allowing regulated actors to plan and implement actions to reduce their emissions.
- **Adoption of 'banking' (transfer of part of permit surplus balance to the next completion period)**, giving participants greater flexibility for complying with their targets.
- **Inclusion of offsets**, since it is an important mechanism of flexibility, but with limited use so that most of the results are obtained by regulated actors themselves. Acceptance of offsets should be grounded in criteria that aims to ensure the environmental integrity of the carbon credits used.