

# Recent emissions trading developments



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## Introduction

At the 2009 Climate Conference in Copenhagen, the international community agreed a maximum global average temperature increase of 2 degrees Celsius in order to combat global warming. To achieve this goal, various forms of CO<sub>2</sub> pricing are being introduced worldwide, including emissions allowance trading. The Swiss emissions trading system (ETS) is an important market-based instrument for climate protection. It serves to reduce the volume of greenhouse gases produced by Swiss companies with particularly high emissions. Since 21 September 2020, Switzerland and the European Union have enabled emissions allowance transactions between the Swiss ETS and the EU ETS.

## Purpose of emissions trading

The United Nations Framework Convention on Climate Change (Climate Convention), which was sealed at the 1992 Earth Summit in Rio, was one of the first milestones for coordinated action against climate change at the international level. Through this convention, the industrialised countries committed themselves to reducing emissions. Since 1995, the signatory states have met annually at the Conference of the Parties (COP). Simultaneously, the COP to the Kyoto Protocol (an addendum to the Climate Convention that requires the industrialised countries to set quantified emission reduction targets) and the Paris Convention (a legally binding agreement adopted in Paris on 12 December 2015 which aims to limit the global rise in temperature to less than 2 degrees) also meet.

Switzerland is particularly affected by climate change, as national temperatures are rising twice as fast as the global average. In 2018 the Intergovernmental Panel on Climate Change advised that serious ecosystem changes can be expected as soon as the average global temperature increases by 1.5 degrees Celsius and that a balanced emissions balance of net zero must be achieved much earlier than planned. As such, on 28 August 2019 the Federal Council decided that by 2050, Switzerland should not emit more greenhouse gases than its natural and technical storage resources can absorb. Switzerland has thus joined a large number of countries that are aiming for net zero emissions by 2050.

## Linking Swiss ETS and EU ETS

More than three-quarters of the total market value of all traded emission allowances are transacted on the European market. The EU ETS covers more than 11,000 installations with over 2 billion tonnes of CO<sub>2</sub>eq, plus aviation (approximately 200 million tonnes of CO<sub>2</sub>eq), which in total covers in the region of 45% of EU emissions. The

operators of around 50 greenhouse gas-intensive industrial plants, which emit approximately 5.5 million tonnes of CO<sub>2</sub>eq, are included in the Swiss ETS. This corresponds to very close to 10% of Swiss greenhouse gas emissions.

On 9 December 2019 Switzerland and the European Union ratified the agreement on linking the Swiss ETS with the EU ETS. The agreement entered into force on 1 January 2020. The initiation of emission allowance transactions between the two systems has been possible since 21 September 2020; the first possible transfer date was 28 September 2020. The agreement regulates the mutual recognition of emission allowances from the two systems, each with its own legal basis. Switzerland therefore does not adopt EU law, but the agreement requires that the two systems be structured equally (principle of equivalence).

Linking the Swiss ETS to that of the European Union has both environmental and economic benefits. It enables companies which participate in the Swiss ETS to trade emission allowances in the EU emissions market, the world's largest market for emission allowances. This access to the market can be a decisive relocation factor for companies in international competition. For energy-intensive industries and fossil-thermal power plants (ie, gas-fired combined cycle power plants), flexibility in emissions trading and the existence of a level playing field with competing companies in the European Union are key. Moreover, thanks to the linking of the two systems and in accordance with EU regulations, air traffic and fossil-thermal power plants are now also included in the Swiss ETS. By the end of 2019, the EU ETS required approximately 500 aircraft operators to cover their CO<sub>2</sub> emissions from domestic and international flights within the EEA with emission allowances. Approximately 180 domestic and foreign aircraft operators are estimated to have obligations under the Swiss ETS (and generally also under the EU ETS).

### **How emissions trading works**

In Switzerland, as in the European Union, companies in certain greenhouse gas-intensive industries (eg, cement, paper, refineries, chemicals, glass, steel and ceramics) must participate in the ETS. In return, they are exempt from paying CO<sub>2</sub> tax.

The ETS operates under the 'cap and trade' principle. An emission allowance entitles the holder to emit one tonne of CO<sub>2</sub>eq under both the Swiss and EU ETS. Each company participating in the ETS is allocated a certain amount of emission allowances. This quantity is reduced annually (cap). Participants in the Swiss ETS and the EU ETS have a comparable cap. If a company emits more emissions than it has the right to, it currently has three options:

- It can buy allowances from another company in the ETS that has not used its own quota (trade) or at an auction by the Federal Office for the Environment (FOEN), (1) the European Energy Exchange AG (EEX) or the Intercontinental Exchange (ICE).
- It can buy emission reduction certificates from climate protection projects abroad, which have been certified in accordance with the Kyoto Protocol (only in limited circumstances).
- It can reduce the produced greenhouse gas emissions in house.

The cap on the Swiss ETS is set in advance for the whole trading period (currently 2013 to 2020), with an annual reduction in the quantity of available emission allowances throughout the system (currently by 1.74%). Each year, 5% of the available emission allowances is retained in case new operators enter the ETS or existing ETS participants plan to expand their production capacity. Emission allowances that are not allocated to companies for free may be purchased at regular auctions by the FOEN. The auction is carried out in a competitive procedure in the form of closed unit price auctions with only one bidding round and is open to Swiss and EU participants.

Trading in emission allowances is distinguished from trading in emission reduction certificates from climate protection projects, which may be used to fulfil obligations to reduce emissions under the ETS. An emission reduction certificate entitles the holder to emit one tonne of CO<sub>2</sub>eq. These emission reduction certificates are an instrument of the Kyoto Protocol, which allows industrialised countries to use flexible mechanisms to credit emission reductions abroad against their reduction targets. However, from 2021 onwards, neither Switzerland nor the European Union will allow emission reduction certificates in the ETS to offset a company's reduction obligations.

### **Control of traded emission allowances**

In order to document and control emissions trading, both Switzerland and the European Union operate an emissions trading register (EHR). The Swiss EHR records:

- emission allowances;
- emission reduction certificates; and
- certificates issued by Switzerland and by companies participating in emissions trading.

The FOEN uses the registry to monitor whether companies have met their legal obligations and conducts auctions of emission allowances. At the same time, the FOEN ensures that the state reduction target is met.

The EHRs are online booking systems. They ensure that the generation, allocation, credit, transfer, acquisition, cancellation and return of units, as well as auction bids, are accurately accounted for. All units exist in electronic form only. While the process is documented in the EHRs, the trade itself is organised by the private sector. The EHRs do not coordinate supply and demand for emission allowances. Since there is no stock exchange trading in emission allowances in Switzerland, they are mainly traded over the counter. There are also intermediaries which trade emission allowances for other ETS participants. In the European Union, emission allowances are traded both over the counter and on stock exchanges. The largest players on the European market are the EEX and the ICE. Prices on the EU secondary market currently range from €20 to €25.

In order to link the EU ETS and the Swiss ETS, an electronic link between the Swiss EHR and the EU EHR is necessary. Both parties have enabled emission allowance transactions between the two registries to be initialised from 21 September 2020. In an initial phase, transfers between the Swiss EHR and the EU EHR are carried out only at fixed times (the first transfer date was 28 September 2020). Transactions within the Swiss EHR are carried out as before.

### **New regulations for 2021**

Switzerland must be able to meet its climate targets without interruption. The existing Swiss legislation (CO<sub>2</sub> Act) stipulates that existing climate policy instruments are limited until the end of 2020. Since the total revision of the CO<sub>2</sub> Act for the period after 2020 has not yet been finalised, on 20 December 2019 Parliament decided that key climate protection measures will be extended until the end of 2021 by means of a further partial revision of the CO<sub>2</sub> Act. The total revision of the CO<sub>2</sub> Act is scheduled to come into force on 1 January 2022. The agreement on linking the Swiss ETS and the EU ETS is aimed at long-term cooperation and therefore indefinite. In order to guarantee the implementation of the planned measures, a further partial revision of the CO<sub>2</sub> Ordinance is necessary.

An important change to the CO<sub>2</sub> Ordinance concerns the cap on the Swiss ETS. In conformity with EU regulations, this will, after 2020, be reduced annually by 2.2% instead of 1.74%. Another important change relates to the free allocation of emission allowances. The revised law provides that the FOEN will retain emission allowances which are no longer allocated to companies due to a decrease in production or business closures in order to make them available to new ETS participants or existing ETS participants with strong growth. This is a key adjustment to the system, particularly in light of the COVID-19 crisis, as it prevents the remaining companies from obtaining more emission allowances due to production cutbacks by companies affected by the crisis.

### **Comment**

International market-based emissions trading creates more flexibility in achieving emission reductions. An ETS is therefore an important instrument in the fight against climate change. Such systems are in operation or under development worldwide at the national and regional level, including in major emitting countries such as the United States and China. In the future, these systems must be linked so that companies worldwide, regardless of their location, have comparable climate regulations. The linking of the Swiss ETS and the EU ETS is the first linking such between states and is an important step towards increased international cooperation in the area of emissions trading.

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### **Endnotes**

(1) The FOEN holds the auctions through the Swiss EHR.

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