



## **Hybrid Liability Revisited: Bridging the Divide Between Seller and Buyer Liability**

**Revised November 2000\***

The “liability” rule for Article 17 emissions trading will address the question of whether countries who participate in trading can redeem assigned amount units originating from Parties that exceed their targets at the end of the commitment period. The rule remains among the most contentious unresolved issues standing in the way of final agreement on this key Kyoto mechanism.

We believe that a hybrid liability rule based upon a *commitment period reserve* would ensure environmental integrity and liquidity of the trading system, and would provide a point of convergence for negotiators. Under our proposal:

- Parties wishing to trade must establish a commitment period reserve of assigned amount units.
- The reserve is created by projecting a five-year emissions trajectory based upon prior emissions inventories.
- The trajectory is adjusted each year to reflect the Party’s annual emissions inventory and expert review of the previous year’s inventory.
- A Party’s net assigned amount (adjusted for acquisitions and transfers) that is surplus to the reserve may be transferred under issuer, or seller, liability.
- Assigned amount that is part of the reserve (i.e., not surplus) may be transferred under user, or buyer, liability.

Some advocates of seller liability have argued that a rule utilizing buyer liability in whole or part would be unworkable because it could trigger a cascading “domino effect” of non-compliance. The effect would make it impossible for potential traders to evaluate the risk of purchases and impossible for Parties to determine whether their legal entities holding buyer liability AAUs were in compliance with their domestic obligations (which in turn would make it impossible for a Party to true-up). Under our proposal, the risk of a buyer liability-induced “domino effect” is eliminated by restricting the invalidation of

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\* An earlier version of this paper was distributed at the CIEL liability side event held in Lyon at SB-13, September 9, 2000. That version did not include the limited buyer liability component proposed in this paper.

buyer liability AAUs to those originating from Parties whose verified emissions for the commitment period exceed their *gross* adjusted assigned amount:

- Gross assigned amount includes *all of the buyer and seller liability AAUs held by a Party* at the end of the true-up.
- After the true-up and expert review, a Party whose emissions exceed its gross adjusted assigned amount is subject to a finding of non-compliance.
- Buyer liability AAUs originating from the non-compliant Party are temporarily invalidated on a last-in, first-out basis, and may not be used by any Party for compliance purposes until the originating Party remedies its excess emissions and returns to compliance.
- Parties holding temporarily invalidated AAUs will face a compliance proceeding if, after the invalidation, their net emissions exceed their adjusted assigned amount and they do not acquire sufficient “good” AAUs to make up the shortfall.
- However, so long as a Party’s emissions do not exceed its *gross* assigned amount—including all AAUs it holds at the end of the true-up, whether they have been invalidated or not—then any buyer liability AAUs originating from it will remain valid and may be used by other Parties and/or private entities for their own compliance purposes.

### *Buyer vs. Seller Liability*

Much of the liability debate has focused on the two extremes of pure seller and pure buyer liability. Under pure seller liability, a Party that acquires AAUs through emissions trading can use them regardless how the Party from whom they originated ultimately performs. Advocates of pure seller liability argue that a strong compliance system will prevent Parties from “overselling,” because if they do transfer too much assigned amount, they will be subject to sanctions under the Protocol’s compliance system. These advocates generally believe that a seller liability rule will be the easiest to administer and will best encourage trades to go forward so that the system flourishes.

Proponents of pure buyer liability respond that seller liability will encourage risky sales, because the buyer will have no incentive to seek AAUs from Parties who have the best chance of meeting their targets. They note two critical problems with seller liability systems. First, there is little assurance that the compliance system will be strong enough to deter overselling or adequately remedy excess emissions caused by overselling (especially if the overselling is due to poor management or planning, and not to “willful” behavior). Second, the largest “seller” countries may not have the technical, regulatory, and political ability to safeguard the integrity of their sales, nor the ability to remedy any emissions excess after it occurs.

Under pure buyer liability, some or all of the AAUs that originated from a Party that exceeds its assigned amount are discounted or invalidated. The discounted or invalidated AAUs could be returned to the seller to assist its own compliance, banked by the

acquiring Party for its use when and if the issuer restores itself to compliance, or simply retired. Either way, the acquiring Party is not able to use the AAUs to meet its target for the commitment period from which they originated.

Generally, we agree that pure buyer liability is preferable to pure seller liability. Under seller liability, only one party to the transaction—the seller—need be concerned about the seller’s compliance. The buyer has no reason to worry, because it will be able to use the tons it purchases regardless of the seller’s performance. Under buyer liability, both parties care. The buyer cares because it may not be able to use some of the tons it purchased if the seller goes out of compliance. The seller cares because it can get a better price for its tons if it can assure the buyer that it is willing and able to comply.

### *A Better Idea: Hybrid Liability*

We believe *hybrid liability* is preferable to either pure buyer or pure seller liability, because of the additional benefits it creates. These benefits include:

- *Enhanced compliance,*
- *Added flexibility,*
- *Greater transparency.*

#### **Enhanced compliance**

Hybrid schemes require that the seller’s performance be tracked during the commitment period. That performance will determine, in part, whether a Party can sell tons under seller liability (enabling it to get the highest price for its tons) or buyer liability (in which case it may not be able to sell at all). Thus, Parties that wish to sell have a strong financial incentive to comply with their obligations by staying within the system parameters (i.e., by not overselling or over-emitting).

#### **Added flexibility**

Under hybrid schemes, buyer liability AAUs and seller liability AAUs will be present in the market at the same time. Thus, purchasers have greater flexibility in designing their “portfolio” of AAUs. For example, buyers may seek to purchase enough seller liability AAUs to cover their expected excess emissions during the commitment period. In addition, they may choose to purchase some buyer liability AAUs as a cost-effective hedge against unforeseen emissions or to bank for subsequent commitment periods.

#### **Greater transparency**

Transparency is the essential ingredient of hybrid schemes. Buyers, regulators, and the public should have access on a daily basis to information about trades. All information about trades should be recorded as they occur in a publicly available registry on an internet web site. That way, anyone with a computer will be able to see at a glance whether Parties are on track to meeting their commitments or veering off course.

## *The “Traffic Light” Approach*

Two years ago CIEL proposed a “traffic light” liability system. This hybrid approach would allow all Annex B Parties to trade initially on a seller liability (i.e., “green light”) basis. The combined rate of emissions and sales during the commitment period would be tracked for each Party. If at any time during the commitment period a Party exceeded its planned trajectory, a “yellow light” would be triggered and the Party could continue to sell only on a buyer liability basis.

It soon became apparent that this system had an inherent flaw: During the time it would take for Parties to submit emissions inventories (about a year), and perhaps have them reviewed by expert teams (another year), much damage could be done. A Party could vastly over-sell before the system caught the problem and triggered the yellow light.

Moreover, as noted earlier, some commentators objected that the presence of a buyer liability component could stifle potential trading because it could lead to a cascading, “domino effect” of non-compliance. They argued that this possibility would make it impossible for potential traders to evaluate the risk of purchasing buyer liability AAUs and impossible for Parties to determine whether their legal entities holding such AAUs were in compliance with their domestic obligations (which in turn would make it impossible for a Party to true-up at the end of the commitment period).

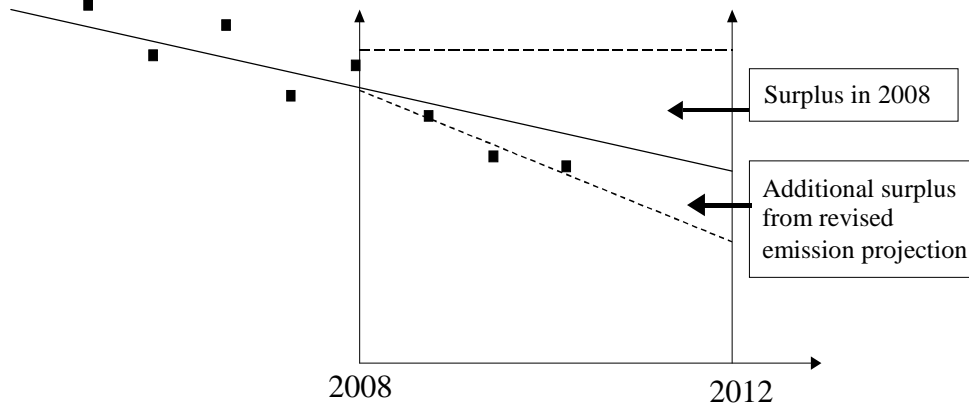
## *Our Revised Proposal: A Commitment Period Reserve with a Limited Buyer Liability Component*

Our revised proposal addresses the “time lag” and “domino” problems by (1) establishing a reserve of assigned amount units prior to the start of the commitment period and (2) limiting the potential invalidation of buyer liability transfers to transfers from Parties whose verified emissions exceed their *gross* adjusted assigned amount.

### **Commitment period reserve**

The commitment period reserve is created by projecting a five-year emissions trajectory for the commitment period for each Party, based on its inventories submitted before the start of the commitment period. The projected emissions are held in reserve. If the projected emissions are less than the Party’s assigned amount, the difference between the two is considered surplus.

The emissions trajectory and reserve are revised annually on the basis of the new inventory and an expert review of the previous year’s inventory. If a Party’s emissions are lower than expected, the surplus is increased (see **Fig. 1**). If they are higher than expected, the surplus is reduced.

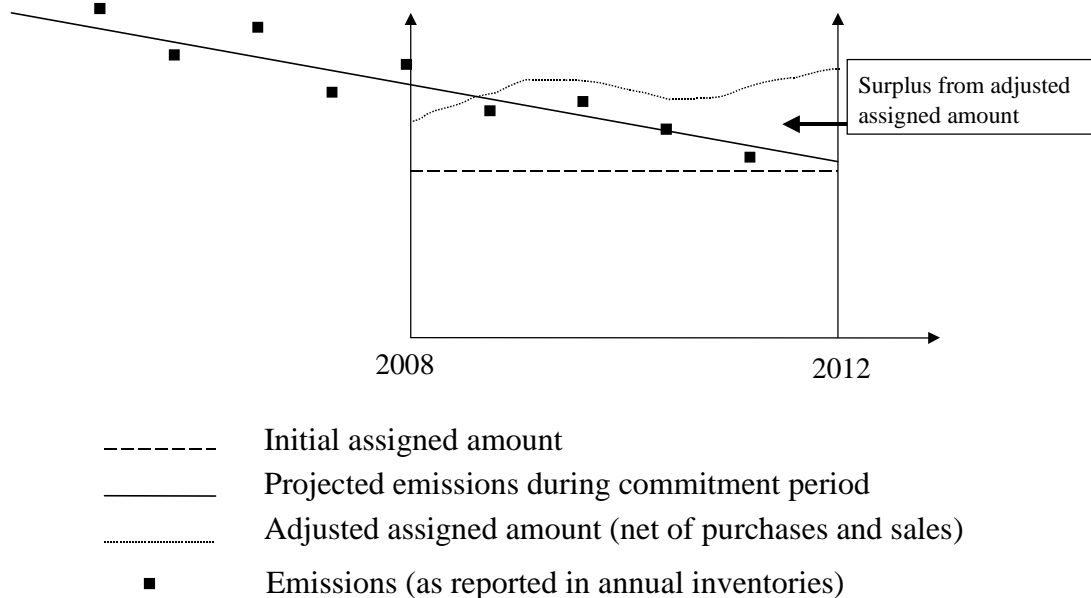


- Assigned amount
- Projected emissions during commitment period
- ..... Revised emissions projection
- Emissions (as reported in annual inventories)

**Figure 1: Trajectory Revised Downward**

Each year during the commitment period, the Party can sell an “annualized” portion of its surplus on a seller liability basis. In other words, during the first year of the period, it can sell up to one-fifth of its surplus under seller liability. During the second year, it can sell up to one-fourth of the remaining, adjusted surplus. During the third year, one-third, etc.

Of course, based on their prior inventories and initial assigned amount (as determined by Annex B and Article 3.7), some Parties might not have any surplus, because their projected emissions (which equal their commitment period reserve) would always be higher than their initial assigned amount. However, Articles 3.10, 3.11, and 3.12 allow Parties to add to or subtract from their assigned amount as they buy and sell through the Kyoto mechanisms. Thus, these Parties may transfer on a seller liability basis as long as their emissions are below their *net* assigned amount, which would equal their initial assigned amount adjusted to reflect transfers and acquisitions of ERUs, CERs, and AAUs (see **Fig. 2**).



**Figure 2: Adjusted (Net) Assigned Amount**

It is important that the reserve be set to match a Party’s actual emissions projections, and not some arbitrarily discounted number. Each Annex B Party’s core obligation under the Protocol is to ensure that its aggregate emissions for the commitment period do not exceed its assigned amount. The incentive structure incorporated within the liability rule should be geared towards fulfillment of that core obligation. The rule should stimulate businesses to lobby their governments for effective, comprehensive national strategies for lowering overall emissions as early as possible, so that the country as a whole will have surplus assigned amount. It should help motivate Parties to lower their actual emissions by rewarding them with the ability to sell the resulting surplus assigned amount at the highest market price. That can be accomplished by giving Parties that hold surplus assigned amount the right to transfer their surplus under seller liability. Any rule that permits Parties to transfer their *non*-surplus assigned amount under seller liability will fail to take advantage of this important compliance incentive.

**Transfers from reserve subject to limited buyer liability**

Even allowing for acquisitions of assigned amount through the Kyoto mechanisms, some Parties may not be able to maintain a net surplus and thus will not be eligible to transfer AAUs under seller liability. These Parties may nonetheless believe it will be advantageous for their domestic businesses to have the freedom to sell AAUs on the international market. They may additionally fear that the opportunity for such businesses to sell under buyer liability will be an empty one, because they may believe no one will be interested in such purchases so long as they could be subject to an unpredictable, seemingly endless “domino effect” triggered when an issuing Party fails to comply with its commitment period target.

Under our proposal, if such a Party (or such a Party’s legal entities) wishes to sell non-surplus tons, it may sell them from the Party’s commitment period reserve on a *limited buyer liability basis*. This buyer liability component lowers the risk that non-surplus transfers from the reserve could ultimately lead to the overall Annex B target being exceeded. In particular, it enhances the prospect of compliance by giving potential purchasers an incentive to evaluate the “credit worthiness” of the issuing country before they buy. At the same time, the limited aspect of this buyer liability component eliminates the possibility of a “domino effect” of non-compliance and invalidation of buyer liability AAUs, which in turn eliminates the main concern that some Parties and businesses have expressed about buyer liability.

After the end of the commitment period—when Annex B Parties have submitted their final inventories, been reviewed by expert review teams (ERTs) pursuant to Article 8, and had an opportunity to true-up their excess emissions by acquiring additional tons via the Kyoto mechanisms—any Party whose net emissions still exceed its adjusted assigned amount will be subject to a compliance proceeding. Under “traditional” buyer liability schemes, if that Party is found to be in non-compliance, the AAUs it transferred under buyer liability are invalidated or recalled in an amount equal to its excess emissions. Any Party holding those invalidated or recalled AAUs may then not have enough assigned amount to cover its own emissions, and will consequently face its own finding of non-compliance. That finding would result in the invalidation or recall of AAUs it had transferred under buyer liability, which could in turn trigger a cascade of non-compliance for even more Parties.

Under our proposal, any invalidation of buyer liability AAUs would be limited to the first “tranche” of non-complying Parties. In other words, invalidation would apply only to buyer liability AAUs originating from those Parties whose aggregate emissions exceed their *gross* adjusted assigned amount—where gross assigned amount includes *all of the buyer and seller liability AAUs held by a Party* at the end of the true-up.

“Invalidation” would be conducted in the same way proposed by the European Union in its “mixed liability” proposal (included as Option 5 in the current Mechanisms text). AAUs originating from a non-complying Party would remain in the registry of the acquiring Party and would not be returned to the issuer. The acquiring Party could retain and bank the invalidated AAUs pursuant to Art. 3.13, but could not use them for compliance purposes until the issuer remedied its excess emissions and returned to compliance.

Limited buyer liability precludes the possibility of an unpredictable “domino effect” of non-compliance. A Party holding invalidated AAUs will still face a compliance proceeding if, after the invalidation, its aggregate emissions exceed its adjusted assigned amount and it does not acquire sufficient “good” AAUs to make up the shortfall. However, so long as a Party’s emissions do not exceed its *gross* assigned amount—including all AAUs it holds at the end of the true-up, whether they have been invalidated or not—then any buyer liability AAUs originating from it will remain valid and may be used by other Parties and/or private entities for their own compliance purposes.

Limited buyer liability allows each Party to evaluate the compliance of its legal entities with their domestic obligations within a finite time. Upon learning that some of the AAUs it held had been invalidated due to the issuer's non-compliance, the holding Party would notify its legal entities who had tendered the AAUs. The entities could be given a brief time to either tender replacement AAUs or pay a significant fine.

Any uncertainty on the part of those entities and their home governments as to whether or not the buyer liability AAUs they had purchased were good would be resolved upon the determination of whether the issuing country's *gross* assigned amount was sufficient to cover its emissions. The entities would have presumably paid for the AAUs based upon the "credit worthiness" of the issuing Party and, depending on the perceived risk, would have made contingency arrangements (such as insurance, additional purchases, or options contracts) to protect themselves against the risk. But since the risk of invalidation will depend only on the performance of the "primary" issuing Party, and not upon the quality of the buyer liability AAUs the issuing Party (and/or its entities) may be holding, entities will not face the task of trying to evaluate an endless web of compounded risk. Accordingly, our proposal will allow buyer liability acquisitions to go forward as a viable option for entities and Parties, while simultaneously providing the sensible safeguards and incentives that buyer liability can bring.

## *Conclusion*

The new hybrid liability rule we propose, based upon a commitment period reserve, solves the problems that were identified with the traffic light approach. Because trades can be registered in real time and made public on the internet, a "yellow light" trigger could operate virtually instantaneously. If a Party oversells without making sufficient upward adjustments to its assigned amount, it will immediately trigger a "yellow light" so that the sale is subject to buyer liability.

The new rule preserves the virtues of the traffic light and other hybrid systems. It enhances compliance by tracking emissions during the commitment period, adds flexibility by giving buyers an option of purchasing either seller or buyer liability allowances, and increases transparency by requiring that all trades be publicly registered as they occur. Finally, it provides liquidity to the market by allowing buyer liability transfers in a way that does not expose potential purchasers to unmanageable risk.

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