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ESG ARTICLES

Emissions Trading System: an instrument to promote the reduction of greenhouse gas emissions

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In September 2016, Mexico ratified the Paris Agreement, thus committing to reducing by 2030 its greenhouse gas (GHG) emissions by 22% compared to its baseline. Even though the Mexican government is mainly in charge of achieving this goal, this is not possible without the active participation of the business sector, as this latter is the responsible for the majority of GHG emissions in Mexico.

To achieve the goal, Mexico has implemented a three-pronged approach, which is constituted by: the holding of public bids for the development of solar, wind and geothermal energy generation projects; the issuance by the Energy Regulatory Commission of clean energy certificates that certify the production of a certain amount of electricity from clean energy; and a reform to the General Law on Climate Change, which, among others, requires the Mexican government to create an Emissions Trading System (ETS).

An ETS is a mechanism for reducing GHG emissions that works in accordance with the "cap and trade" principle.[1] That is, the government imposes a limit on GHG emissions in certain sectors of the economy. Limits will decrease over time so that, consequently, GHG emissions are reduced. Companies must have permits for each ton of GHG emissions that they release into the atmosphere. If they do not have enough permits to cover their emissions, they must reduce them or buy permits from other companies, which in turn must lessen their emissions according to the number of permits or rights sold.

Prior to the ratification of the Paris Agreement in 2016, Mexico already had various mechanisms in place to reduce GHG emissions, such as the tax on fossil fuels for carbon content, approved by the Congress in 2013 and enforced since January of 2014.[2] However,

1 Environmental Defense Fund, *How cap and trade works*, accessed on July 27, 2021, available at: https://www.edf.org/climate/how-cap-and-trade-works
2 Article 2, Section I, subsection H, Special Tax on Production and Services Law, available at: http://www.diputados.gob.mx/LeyesBiblio/pdf/78_241220.pdf

the argument behind the mandate to create an ETS is that this system offers the possibility of "promoting the reduction of emissions with the lowest possible cost, in a measurable, reportable and verifiable way, without undermining the competitiveness of the participating sectors in the international markets".[3]

In other words, although in recent times it has become a trend to be a "sustainable" company,[4] the reality is that companies are looking for real and measurable incentives to put aside the use of fossil fuels, which in most cases are much cheaper than green fuels. Therefore, the implementation of an ETS is one of the resources of the Mexican government to achieve the goals of the Paris Agreement, by requiring and incentivizing companies in Mexico to use green fuels or to modify their operations to reduce their GHG emissions.

As a part of the sustainability policies in the country, the ETS is an effective and binding instrument to encourage companies in Mexico to implement measurable strategies to reduce their carbon footprint.[5]

Currently, the ETS is in a test stage in which the only participants are the facilities that carry out activities in the energy and industry sectors,[6] and whose annual emissions are equal to or greater than 100,000 tons of direct carbon dioxide emissions.

It is worth noting that the ETS test program has been delayed as the Ministry of the Environment and Natural Resources is still in the process of assigning emission rights.[7] That is the reason why it still does not have economic consequences (fines or payment for emission rights) since its purpose is for market participants to know how the ETS works. However, since the ETS to be implemented in Mexico is based on international models,[8] it is expected that sanctions and fines will be established for GHG emissions higher than those authorized.

The criticism to the Mexican ETS is due to the supposed impact that the obligation to reduce emissions will have on the Mexican market and economy. However, this is interesting since these types of systems have been successfully implemented around the world since 2005, when the European Union implemented the first ETS.[9]

Moreover, combating climate change from the business sector also has consequences on the ability of companies to attract new talent. Companies with high emissions have found it more difficult to recruit employees. By participating in the ETS, reducing emissions and selling emission rights, companies guarantee compliance with legislation, eliminate risks of fines and penalties, promote good environmental practices and acquire an unrivaled reputation in the market.

Thus, the execution of the ETS in Mexico should be seen as an area of opportunity for companies in the energy and other industrial sectors. The Paris Agreement has caused a large majority of national and international investors to incorporate environmental aspects in the risk valuations that they engage to evaluate future investments in a company. This, for the investor, brings the advantage of knowing the company's environmental policy and the possibility of investing in a sustainable company that is

3 Ministry of the Environment and Natural Resources, *Programa de prueba del sistema de comercio de emisiones*, accessed on July 27, 2021, available at: https://www.gob.mx/semarnat/acciones-y-programas/programa -test-of-emissions-trading-system-179414

4 The generally accepted definition of "sustainable business" is the one that has practices that meet the needs of the present without compromising those of future generations. United Nations, *Report of the World Commission on Environment and Development: Our Common Future*, accessed on July 27, 2021, available at: https://sustainabledevelopment.un.org/content/documents/5987our-common-future.pdf

5 Greenpeace México, *Huella de carbono: aprende a calcular tu impacto ambiental*, available at: https://www.greenpeace.org/mexico/blog/9386/huella-de-carbono/

6 Official Federal Gazette, accessed on July 27, 2021, available at: https://dof.gob.mx/nota_detalle.php?codigo=5573934&fecha=01/10/2019

7 Ministry of the Environment and Natural Resources, *AVISO. Programa de Prueba del Sistema de Comercio de Emisiones*, accessed on July 27, 2021, available at: https://www.gob.mx/cms/uploads/attachment/file/606638/Aviso-Sistema-de-Seguimiento.pdf

8 Official Federal Gazette, accessed on July 27, 2021, available at: https://dof.gob.mx/nota_detalle.php?codigo=5573934&fecha=01/10/2019

9 European Commission, *EU Emissions Trading System*, accessed on July 27, 2021, available at: https://ec.europa.eu/clima/policies/ets_en

effectively implementing a measurable mechanism for reducing its carbon footprint. For companies, it translates into an alternative that will allow them to comply with the applicable regulations with measurable environmental standards that contribute to the sustainable development of their business,[10] in search of attracting more and better investments and clients.[11]

10 United Nations General Assembly, *Sustainable development*, available at: https://www.un.org/es/ga/president/65/issues/sustdev.shtml.

11 Rob Bailey and Lucy Clarke, *Climate Change is an Enterprise Risk Multiplier*, NACG Board Talk, accessed on August 3, 2021, available at: https://blog.nacdonline.org/posts/climate-change-risk-multiplier

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