

# Global Climate Governance:

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Scenarios and Options on the Inter-Linkages between  
the Kyoto Protocol and other Multilateral Regimes



The United Nations  
University

**UNU/IAS**



Global Environment  
Information Centre

# Global Climate Governance

## Scenarios and Options on the Inter-Linkages between the Kyoto Protocol and other Multilateral Regimes

*A Project of the United Nations University Institute of Advanced  
Studies and the Global Environment Information Centre*

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List of Abbreviations

AIJ	Activities Implemented Jointly	MMT	Methylcyclopentadienyl Manganese Tricarbonyl
AIPN	Association of International Petroleum Negotiators	NAFTA	North American Free Trade Agreement
BIA	Bilateral Investment Agreement	NT	National Treatment
BOT	Build Operate and Transfer	ODS	Ozone Depleting Substance
CBD	Convention on Biodiversity	PAMs	Policies and Measures
CDM	Clean Development Mechanism	PPM	Production and Processing Methods
CEC	Certified Emission Credits	QELR	Quantified Emission Limitation Reduction
CER	Certified Emission Reductions	QELRO	Quantified Emission Limitation Reduction Objectives
CFC	Chlorofluorocarbon	SO <sub>2</sub>	Sulphur di-oxide
CITES	Convention on International Trade in Endangered Species of Wild Fauna and Flora	SPS	Sanitary and Phytosanitary (GATT, 1994)
CO <sub>2</sub>	Carbon di-oxide	TBT	Technical Barriers to Trade Agreement (GATT, 1994)
COP	Conference of the Parties	TREM	Trade Related Environmental Measure
CTE	Committee on Trade and Environment	TRIM	Trade Related Investment Measure
DSB	Dispute Settlement Body	UNCITRAL	United Nations Commission on International Trade Law
DSP	Dispute Settlement Provision	ICC	Court of Arbitration
DSU	Dispute Settlement Understanding	UNCTAD	United Nations Conference on Trade and Development
EIT	Economy in Transition	UNIDO	United Nations Industrial Development Organisation
ERT	Emission Reduction Targets	UNFCCC	United Nations Framework Convention on Climate Change
ERU	Emission Reduction Units	UNU	United Nations University
ETC	Emission Trading Contract	UNU/IAS	United Nations University Institute of Advanced Studies
EU	European Union	WTO	World Trade Organization
FCCC	Framework Convention on Climate Change		
GATS	General Agreements on Trade in Services		
GATT	General Agreements on Tariffs and Trade		
GEIC	Global Environmental Information Centre		
GHG	Greenhouse Gas		
HFC	Hydrofluorocarbon		
ICC	International Chamber of Commerce		
ICJ	International Court of Justice		
IFF	Intergovernmental Forum on Forests		
IPF	Intergovernmental Panel on Forests		
ISO	International Standards Agreement		
ITTO	International Tropical Timber Organisation		
JI	Joint Implementation		
JOA	Joint Operating Agreement		
JVA	Joint Venture Agreement		
KP	Kyoto Protocol		
MAI	Multilateral Agreement on Investment		
MEA	Multilateral Environmental Agreement		
MFN	Most-Favoured-Nation Status		
MOP	Meeting of the Parties		



# Foreword

The United Nations University, Institute of Advanced Studies (UNU/IAS) and the Global Environment Information Centre (GEIC) compiled this study in an effort to both continue, and complement, the research presented in *Report – Part One. Global Climate Governance: A Report on the Inter-linkages between the Kyoto Protocol and other Multilateral Regimes*.

The aim of *Report – Part One* was to identify the issues relating to potential synergies and incompatibilities between the Kyoto Protocol and other multilateral regimes. *Report – Part Two* extends upon the original study and explores the practical implications of the key issues. These issues are explored through the creation of fictitious scenarios that highlight some of the difficulties that may be encountered once the Kyoto Protocol flexibility mechanisms become operational. The core objective of the study is to not only suggest and explore potential problems in implementation, but also to suggest and explore possible solutions. A notable conclusion of the study is that most solutions are embedded within a more integrated approach to environmental problems and environmental problem solving.

The research presented in this report forms a fundamental component of a broader research framework developed by the UNU/IAS *Environment and Multilateral Diplomacy Project*, in conjunction

with its affiliates and contributors. A core focus of the project is the interaction between societal and natural systems or, more specifically, the interaction between multilateralism and the environment. Both these systems are highly complex and require a holistic framework of understanding.

Thus far, decision-making at both the national and institutional level has responded to environmental problems in a fragmented and extemporized manner. In order to govern the global environment effectively the development of a systems approach is required urgently. International institutions, and national governments, must be prepared to address environmental governance from a cross-sectoral perspective with an increased level of integration. Only then will the multilateral environmental system be governed in an effective, coordinated, coherent, and synergistic manner.



## 1

# The Kyoto Protocol

In 1997 delegates to the third session of the Conference of the Parties (COP) to the UN Framework Convention on Climate Change (FCCC) agreed, by consensus, to adopt a Protocol under which industrialized countries would reduce their combined greenhouse gas (GHG) emissions by at least 5% compared to 1990 levels. To have any hope of achieving these emission reductions, and prevent dangerous anthropogenic interference with the global climate, will require a fundamental change in the way that energy is produced and the way it is used. It will also require a basic reassessment of the manner in which fossil fuels are utilised. This factor, in itself, is enough to catapult the Protocol out of the purely environmental realm and into the domain of global economics.

Yet the economic relevance of the Protocol is not limited to its overall efforts to curb the use of fossil fuels in an attempt to reduce potentially harmful emissions. Its economic relevance also stems from the unique manner in which countries may seek to achieve their reduction commitments. At this point, it is only the developed countries that have committed to reducing their greenhouse gas emissions. It was recognized during the Kyoto negotiations that many developed countries would find it difficult to achieve their target reductions solely on the basis of domestically implemented policies and measures (PAMs). Developing countries, on the other hand, may possess a greater scope

for creating real reductions in emissions as their resource and industrial bases are not yet developed to their fullest capacity.

In an effort to assist developed countries in achieving their emission targets, and also promote ecologically sustainable development in developing countries, a number of unique market-based flexibility mechanisms were incorporated within the Kyoto Protocol. Essentially, these mechanisms constitute ways in which developed countries can supplement their domestic efforts to achieve their emission reductions by implementing specific projects and policies offshore. All three of the mechanisms: Joint Implementation (JI), Article 6; the Clean Development Mechanism (CDM), Article 12; and Emissions Trading (ET), Article 17, rely on existing economic forces to make them viable. Within the context provided by the flexibility mechanisms emission reductions can be considered as economically valuable units in terms of trade and investment. They can be deliberately produced, traded on the open market, saved, or used as part of a country's efforts to meet its own reduction targets.

If emission reductions achieved within the process of arresting climate change become an economic commodity this will have serious implications for attempts to create an integrated



and effective environmental protection regime. The UN Framework Convention on Climate Change and the related Kyoto Protocol is still being explored in terms of the potential conflicts and synergies with other multilateral environmental agreements. With its added economic dimension, the Convention and its Protocol must now also be considered in terms of the potential points of synergy and conflict with existing and proposed economic regimes such as the World Trade Organization (WTO), the proposed Multilateral Agreement on Investment (MAI), and private and contractual law.

The practical and operational details relating to the implementation of the Protocol's flexibility mechanisms have yet to be elaborated, yet many potential points of conflict and synergy have already become apparent. It has also become clear that it is in the elucidation of the guidelines and procedures for implementation that many of the likely points of conflict can be avoided. Successful, synergistic, implementation depends upon the identification and removal of potential ambiguities. These include the responsibilities and rights of the various governmental and non-governmental actors involved as well as the jurisdictions of the differing economic and environmental regimes.

Synergistic implementation also depends upon a shift towards a more integrated approach to environmental policy making. The global environment is a whole and can only be protected effectively if it is approached holistically. This cannot be achieved unless meaningful coordination occurs at, and between, the international and national levels of policy making. A higher level of integration is required between different international regimes and their associated administrative bodies, between different multilateral environmental agreements, and between different national bureaucracies.

Effective environmental protection will be impossible unless the different international regimes, and the relevant environmental bodies, locate their common ground and actively coordinate their policies.

Given its highly economic nature, the success of the Kyoto Protocol is dependent upon its implementation being approached in a manner consistent with emerging trends toward international free trade. These trends have been expressed through existing international trade regimes such

## Summary

## 2

# The Kyoto Protocol and the International Trade Regime

as the WTO, NAFTA, and the EU. This need to provide for policy coherence has been recognised explicitly within both the Climate Change Convention and the Kyoto Protocol.

On a broad level, compatibility is a realistic ambition in the sense that the overall objectives of the Convention and Protocol are in no way contra to the protection of free trade. Yet, this broad conceptual compatibility does not necessarily guarantee compatibility at the practical operational level. This will, to a great extent, depend on how the market based flexibility mechanisms are defined and implemented. The overall goals of free trade and environmental protection may be consistent, but the specific details of their pursuit may not.

Essentially, the potential point of conflict hinges upon the issue of discrimination. The fundamental objective of existing trade regimes is to remove any form of discrimination that may act as a barrier to free trade. The market mechanisms within the Protocol, because they distinguish between developed and developing countries, between signatories and non-signatories, and between different manufacturing technologies and processes are effectively dependent upon the very form of discrimination that the WTO and other trade regimes attempt to eliminate.

It has been recognised within the WTO,

NAFTA, and the EU that multilateral environmental agreements are the most effective method of organizing a global strategy to address issues such as climate change. All three have, at a framework level, accepted that some forms of discrimination will be necessary to ensure that the relevant environmental agreements can be effective. What is worrying to members though, is the potential creation of loopholes through which member's rights may be eroded. They want to ensure, as do those who are responsible for elucidating upon their detail, that the specific allowances made for the implementation of the flexibility mechanisms do not undermine the overall objective of free trade.

The issues that need to be clarified relate to the particular circumstances under which specific clauses and conditions within various trade agreements will be suspended, or waived, in order to facilitate effective implementation of the mechanisms. Such measures will be necessary in order to allow for differentiated treatment, the promotion of environmentally sustainable projects and industries, and the imposition of environmental standards and regulations.

To avoid potential conflict between the two regimes, allowances and exemptions made in respect to the implementation of the mechanisms must be stringently controlled and codified, and

kept to a minimum. Necessary forms of discrimination must be transparent and clearly justifiable in environmental terms. Similarly, measures designed to offset the costs of adjusting to new environmental standards must be proportional to the level of burden imposed. It is crucial, also, that lines of responsibility and respective jurisdictions be established and recognized formally before any points of confusion or contradiction actually arise.

The following scenarios have been constructed in an attempt to identify and explore potential conflicts that may arise as a result of ambiguities regarding the implementation of the market mechanisms outlined in the Kyoto Protocol.

### Scenario One

*Keyword Outline: Developed Countries vs. Developed Country, WTO members, like products, border tax, Article XX exceptions.*

Country 'A' is an Annex I party to the Kyoto Protocol and has committed to substantial reductions in its GHG emission levels. In an effort to meet its commitments it has adopted a two-pronged domestic strategy. It intends to switch to alternative energy sources and also impose higher standards of emissions control on fossil-fuel-intensive energy producers and users. The latter initiative will result in cleaner technologies that reduce the emission of GHGs into the atmosphere. These policies, as would be expected, exert upward pressure on the price of energy in Country 'A'.

Country 'B' is also an Annex I Party to the Kyoto Protocol. It is reluctant, however, to impose taxes or any other form of regulation that would increase production costs and the selling price of domestic energy sources. This policy decision is based on an assumption that the economy could not sustain any significant decrease in the competitiveness of its products. The methods Country 'B' chooses to carry out its responsibilities under the Protocol are: to increase the efficiency of its manufacturing sectors, impose technical restrictions on household items, and invest in public transportation. It plans to achieve the remainder

of its commitment using the flexible mechanisms outlined in Article 12 and 17 of the Protocol.

Country 'A' is one of the largest importers of energy from Country 'B'.

Domestic energy producers in Country 'A' complain that they cannot compete against cheap, unregulated, untaxed, energy sources in Country 'B'. In response to the pressure exerted by domestic energy producers, Country 'A' imposes a border tax on energy imports from Country 'B'. The tax is imposed on imports of both carbon-emitting and non-carbon-emitting energy sources and is levied on the basis of both carbon content and energy content.

Country 'A' argues that the energy-import-tax is necessary for it to meet its obligations under the Kyoto Protocol. It argues that the tax is a legitimate trade barrier under Article XX, *General Exceptions*, paragraph (b) of the GATT provisions of the WTO and is necessary to protect human, animal and plant life from the threat of global climate change.

Country 'B' protests against the tax as it affects the competitiveness of its energy exports and is discriminatory under Article I, *General, Most-Favoured Nation Treatment* (MFN), and Article III, *National Treatment on Internal Taxation and Regulation* (NT), of the GATT provisions.

### Issues and Outcomes

While the arguments of both countries have merit it is unlikely, according to current interpretations of WTO regulations, that Country 'A' could defend its tax successfully. The issues discussed within this scenario highlight two key issues that are the subject of controversy within the trade and environment debate, like-products, and Article XX exceptions to the GATT.

One of the key arguments against the border tax relates to the question of what constitutes 'like products'. For the purposes of the WTO, production process methods are not a consideration in determining the likeness of two

products. WTO rules establish likeness according to 'the end-use in a given market', the 'consumers tastes and habits', or according to the product's 'property, nature and quality'. In the context of this scenario all energy, whether it is solar, wind, or fossil fuels intensive, has the same end-use; consumers normally do not have the opportunity to choose between different types of energy (hydro vs. coal-firing); and the final energy products have the same physical characteristics.

According to this criteria both Country 'A' and Country 'B' energy are like products and taxes, or other measures that would discriminate against energy products on the basis of production process methods, are prohibited. For this reason any tax imposed on imported products cannot be greater than the tax imposed on like products manufactured and sold domestically. The Country 'A' border energy tax clearly fails to meet this regulation and is likely to be considered as unjustifiable discrimination.

The second issue highlighted within the scenario relates to Article XX exceptions within the GATT provisions. While the core objective of the WTO is the removal of all unfair trade barriers, the need to make exceptions in an effort to protect the environment has been recognized. The provisions made within the GATT to accommodate environmental exceptions to its rules are:

### Article XX

#### General Exceptions

Subject to the requirement that such measures are not applied in a manner which constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:

(b) necessary to protect human, animal or plant life or health;

(g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;

In this scenario Country 'A' defends its energy import tax on the basis of the exception outlined under XX(b), as necessary to protect human, animal or plant life or health. This rationale was chosen because it was thought to most accurately describe the objectives underpinning the tax. Country 'A' argues that the purpose of the tax is to assist the state to meet its GHG emission reduction commitments under the Kyoto Protocol. The Protocol having the same purposes as the FCCC was put in place to ensure that dangerous anthropogenic GHG do not threaten the climate system which could then harm human, animal or plant life or health.

While basing a defense of the border tax on the necessity to protect human, animal or plant life or health may seem a more direct link to the domestic measure's intent, its potential to succeed as an exception has been limited by the narrow interpretations of past WTO/GATT panels. The difficulty lies in the interpretation the word necessary. To prove that the measure adopted is necessary it must pass a series of tests that determine its compatibility with the overall objectives of the WTO.

To pass these tests a country must be able to prove that it has adopted the least GATT-inconsistent measure and that its actions will have the least possible impact on trade liberalization. It is the level of GATT-consistency, according to WTO principles, that represents the first and foremost test of a policy's environmental legitimacy. The primary consideration of any WTO panel will not be the impact that the measure will have on the environment, but the impact that it will have on free trade.

The legitimacy of the measure will also depend upon the country's ability to demonstrate that there is no reasonable alternative available that would have less of an impact on the GATT. The test weighs heavily in favor of protecting trade liberalization, rather the environment, and would make it difficult for Country 'A' to defend its tax. Country 'B' could simply argue that Country 'A' would have interfered less with the GATT provisions if it had implemented measures similar to

its own.

The GATT-compatibility test is underpinned by an assumption that states will try to use trade-related environmental measures to disguise economically motivated trade barriers. While this is a valid possibility the WTO must recognize that states may be genuinely motivated by concern for the environment. State decision-makers will often determine what they consider to be appropriate measures according to expectations of environmental effectiveness, efficiency of implementation and monitoring, and cost effectiveness. Yet, under current interpretations of the GATT XX (b), a consideration of such factors is overshadowed by the need to meet the least-trade-restrictive requirement.

Country 'A' may have had a better chance of defending its tax if it had been able to argue its case on the basis of the Article XX(g) exception, that is, that its measures were related to the conservation of an exhaustible natural resource. The justification for the border tax would have been easier to prove under this exception because has only to be *related* to an environmental protection issue, not *necessary* for it. Whether a case such as this could be argued under the exception under Article XX(g) depends on the WTO's interpretation of several key issues.

The WTO Appellate Body *Shrimp-Turtle* Decision of 12 October, 1998, does suggest that the WTO interpretation of some of the key issues relating to Article XX(g) exceptions is beginning to change. Article XX (g) has become a much more likely foundation for a defence of discriminatory domestic policies aimed at environmental protection. The 1998 *Shrimp-Turtle* appellate body decision clarified past WTO interpretations of the (g) provision and put in place a series of tests that appear to strike a more appropriate balance between the trade and environment regimes.

The first test to the XX(g) exception is

whether the policy measure is aimed, clearly, at protecting an exhaustible natural resource. The Appellate stated that the relationship between the measures undertaken, and the environmental objective, must be unambiguous. In the *Shrimp Turtle* Appellate case the fact that the US imposed the same turtle excluder regulations on the domestic shrimp industry was considered adequate to meet this requirement. It was considered to be evidence that the US action stemmed from a genuine environmental concern and was not a disguised trade barrier. In the case outlined in the scenario, Country 'A' could not have defended its tax on the basis on XX(g) because it did not impose an equivalent tax on domestic energy producers.

The second test requires a determination as to whether the resource at issue is exhaustible. The *Shrimp-Turtle* ruling dealt with this question at some length because the Principals to the dispute argued that under a 'reasonable interpretation of the term exhaustible that it refers to finite resources such as minerals rather than biological or renewable resources.' The Appellate body did not agree with this argument and ruled that, as a species of plant or animal can become endangered, it is exhaustible. This allows Article XX(g) to be used in a much wider range of circumstances than it had previously been associated with.

Similarly, the question as to whether the global climate can be considered an exhaustible natural resource will be crucial to the implementation of the Climate Change Convention in the future. The WTO has not yet been called upon to make a ruling on this issue although past precedence suggests that such an argument could succeed.

A comparable question was raised in the *Reformulated Gasoline Panel*, involving a dispute between the US and Venezuela over compositional and performance specifications for reformulated gasoline entering the US. The Panel noted that clean air could be considered to be an exhaustible natural resource as it has value, is natural, and can be depleted. Taking this ruling into account the global climate, with similar attributes to clean air, could also be considered as falling within the definition of Article XX (g).



The third test is referred to as the *Chapeau* Test. In the chapeau introducing Article XX, *General Exceptions*, it is stated that measures cannot be taken that would discriminate between countries where the same conditions prevail. The effect of this statement is that a country cannot discriminate against another country in an attempt to force that country to comply with its own regulatory program or policy goals.

In the scenario Countries 'A' and 'B' have similar prevailing conditions, they are both Annex I countries attempting to meet their Kyoto commitments. They have, however, chosen different methods of achieving their commitments. If a WTO panel was required to provide a ruling on this case based on the Chapeau Test the Country 'A' tax would be ruled invalid. It would be considered to be a discriminatory measure that penalized Country 'B' for not undertaking the same policy options as Country 'A' in an effort to meet its Kyoto commitments.

### *Options*

- Under GATT Article XX (b) consider a more balanced proportionality test between the environmental measure and the inconsistency with the GATT rules. The article requires a 'rule of reason' that judges the measure 'necessary' in order to protect human, animal or plant life or health while being proportional to the rules and principles under the WTO. Such a rule is essentially a test of reasonableness, could an alternative measure have achieved the same level of protection to human, animal, or plant life? If so, would the measure have been feasible to implement, would it be cost-effective, could it be monitored, would it be consistent with national legislative practices etc. If such reasonableness is taken into account, a level of equity will be reached between the environment and trade which is not currently reflected in the overly strict 'necessary' test of XX (b).
- Consider giving greater effect to Article 4.2 subparagraph of the Climate Change Convention, which calls

on parties to coordinate their national policies so that conflicts over different implementation techniques do not arise. Although the national communications do normally contain the general policies taken to reduce emissions perhaps, in an effort to increase transparency, a separate notification and registry system could represent one concrete option.

### **Scenario Two**

*Keyword Outline: Developed Country vs. Developing Country, WTO members, Measure pursuant to an MEA, common but differentiated responsibility.*

Country 'C' is an Annex I party to the Kyoto Protocol and has made a commitment to reduce its GHG emissions by 5% of its 1990 levels. It decides to implement the Protocol through an aggressive scheme that taxes large energy users such as aluminum and steel producers.

Country 'D' is also a Party to the Kyoto Protocol. It is a Non-Annex I country and, according to the doctrine of common but differentiated responsibility, it is not required to set a substantive target under the Protocol. Country 'D' has, on a voluntary basis, introduced a number of GHG reduction programs. It is also undertaking to heighten awareness of the necessity for sustainable development practices amongst decision-makers in business and industry.

Country 'D' exports a large amount of steel to Country C.

Prior to Country 'C' implementing the Kyoto related tax regulations the two countries competed vigorously in both the international and domestic steel markets. Once the tax on large energy users was imposed, the Country 'C' share of the domestic steel industry steadily declined as manufacturers were forced to increase prices to account for the tax. The limited number of domestic steel producers that chose to maintain prices, in an effort to compete with Country 'D' steel, have suffered from dwindling profit margins. Domestic steel producers in Country 'C' have, as a consequence, demanded that the imposition of higher tariffs on all foreign steel that does not

impose a GHG standard on its producers. In response to this pressure Country 'C' has imposed a border tax on all steel, and steel products, that would have been targeted by the domestic tax had they been produced locally.

Country 'D' demands that the border tax be lifted on the grounds that it has a negative impact on its trade and is discriminatory. Country 'D' argues that, as it is not an Annex I party to the Kyoto Protocol and is not subject to same obligations as Country 'C', it should not be affected adversely by any measures Country 'C' undertakes in an effort to meet its emission reduction targets. It reminds Country 'C' that developing countries have, throughout history, produced low per capita GHG emissions and for this reason they do not have numerical emission reduction targets under the Climate Change Convention. Its claims are ignored by Country 'C'.

In recognition of the direct link between the Country 'C' tax and the application and implementation of the Kyoto Protocol, Country 'D' considers referring the case to the FCCC dispute settlement procedure. Like most parties to the FCCC, however, Country 'C' did not agree to the compulsory settlement of disputes and would be unlikely to agree to allow the International Court of Justice (ICJ) to rule on the case. Country 'D' considers the possibility of requesting a conciliation commission but then rejects this option because the commission's recommendations are not binding. Faced with no apparent recourse under the Climate Change Convention Country 'D' undertakes a retaliatory measure and imposes a tax on Country 'C' steel, equivalent to same tax imposed earlier by Country 'C'.

Country 'C' immediately protests against the tax arguing that it is discriminatory under Article I, *General, Most-Favoured Nation Treatment*, and Article III, *National Treatment on Internal Taxation and Regulation*, of the GATT provisions. Country 'C' claims discrimination on the basis that Country 'D' has not imposed an equivalent tax on own domestic steel producers.

The case is referred to the WTO and Country 'D' defends its tax as an Article XX(g)

exception pursuant to the UNFCCC Kyoto Protocol. Country 'D' argues that the tax is a legitimate Article XX(g) exception because the Kyoto Protocol is a widely endorsed MEA with over one hundred and seventy signatories.

### *Issues and Outcomes*

*Scenario Two* raises issues similar to those in *Scenario One*, whether production process methods can be used in determining like-products, and what kind of situation would constitute an Article XX exception to the GATT. *Scenario Two* also raises issues relating to the potential complications involved in justifying discriminatory measures as pursuant to a multilateral environmental agreement, in this case, the Kyoto Protocol.

The Country 'D' border tax on Country 'C' steel is discriminatory, the question is, can it be justified as an exception under Article XX (g), of the GATT provisions. In its defense Country 'D' assumes that its claim to a GATT exception holds more weight because it is required for Country 'D' to meet its obligations as a Non-Annex I signatory to the Kyoto Protocol. The key issue, then, is whether commitments under a universally adopted multilateral environmental agreement constitute a legitimate cause for a GATT exception.

The most relevant precedent set in regard to this issue relates to the *Tuna-Dolphin* disputes between the US and Mexico in 1991, and 1994. These trade disputes erupted in response to the US decision to place restrictions on tuna imports from Mexico on the basis of their dolphin-unfriendly harvesting techniques.

One of the key issues debated by both the 1991 and 1994 *Tuna-Dolphin* panels related to the issue of extraterritoriality, whether the US could adopt measures to protect resources outside its territory. Neither panel adopted definitive rulings on the issue of territoriality but what is of interest to this scenario is that the 1991 GATT panel noted that the existence of a relevant multilateral environmental agreement would have impacted on its ruling on the territoriality issue. The panel implied that commitments under a multilateral environmental agreement were considered to be

a potentially legitimate reason for an exception to the GATT conventions.

The GATT panel noted in the *Tuna Dolphin I* case that a ruling against the US action would be justified because the US had not exhausted all other efforts available under international law to protect dolphins: “The United States had not demonstrated to the panel that it had exhausted all options reasonably available...in particular through the negotiation of international cooperative agreements...” This suggests that the US action may have been considered differently if it had been taken pursuant to a recognized international environmental agreement. The claim for an Article XX exception would have, effectively, been considered to have a greater legitimacy if it had been made within the specific context provided by a recognized MEA.

Granting exceptions on the basis of MEAs would not be inconsistent with the WTO’s treatment of other, universally accepted, international agreements. The GATT, for example, is explicit in its recognition of the legitimacy of other bodies of international law such as the United Nations Charter. Article XXI(c) provides that the GATT should not restrict any Member from “taking action in pursuance of its obligations under the UN Charter for the maintenance of international peace and security.” Trade sanctions imposed by the Security Council under the authority of Chapter VII of the UN Charter have become an, almost routine, response to threats to international peace.

The UN Charter is unique in that it is a universally accepted document of a largely constitutive nature. In legal terms, though, other international agreements with similar degrees of universality should be regarded with a similar level of legitimacy. This includes their general recognition as a legitimate exception under Article XX of the WTO. The Climate Change Convention, with over one hundred and seventy signatories, is just such an international agreement.

Additional arguments supporting the role of MEAs as legitimate grounds for GATT exceptions stem from within the WTO itself. Attempts have been made, under the umbrella of the WTO,

to harmonize a number of different international regulations with the provisions of the GATT. The 1994 Technical Barriers to Trade Agreement (TBT) negotiated in the Uruguay Round is a case in point. The successful negotiation of this agreement indicated that international technical standards were thought to provide a legitimate foundation for the creation of national technical regulations affecting trade. This is believed to be the case, however, only insofar as the standards or regulations are considered to be effective, or appropriate, for a legitimate purpose. Article 2.4 of the TBT Agreement states:

Where technical regulations are required and relevant international standards exist or are imminent, Members shall use them, or relevant parts of them, as a basis for their technical regulations except when such international standards or relevant parts would be ineffective or inappropriate means of fulfillment of the legitimate objectives pursued.

While the definitional parameters of what constitutes *effectiveness* or *appropriateness* is yet to be put to the test the provision, as it stands, is significant. It implies that a wide array of standards, including those adopted by the International Standardization Organization (ISO), or perhaps eco-standards, could serve as a legitimate cause for an exception to GATT provisions. If the relationship between certain eco-standards and environmental protection are codified and universalized within an MEA these standards could then, according to the TBT Agreement, be considered as legitimate exceptions to the WTO ban on technical barriers to trade.

It is clearly stated within the Kyoto Protocol that there are two separate sets of obligations for developed and developing countries. In imposing the retaliatory energy tax, Country ‘D’ has put forward the argument that it is simply attempting to uphold its obligations as a developing country signatory to the Protocol. It argues that it has no reduction obligations under the Protocol and is under no obligation to absorb the negative consequences of Country ‘C’s attempts to meet its Annex I obligations.

At present, Country ‘D’s attempts to justify an exemption from various GATT provisions



and defend its retaliatory border tax is unlikely to be successful. The legitimate role of MEAs is yet to be determined in relation to WTO rules and regulations.

Even if it were able to defend this argument questions might also be raised in regard to the true purpose behind the tax. The onus would be on Country 'D' to prove that its border tax was related directly to the Kyoto Protocol and not an attempt at retaliating against Country 'C's tax.

A second element that may serve to undermine the argument of Country 'D' is, again, the application of 'unjustifiable discrimination' where the same conditions apply. Would Country 'C', although obligated by the Kyoto Protocol, not be free to choose its own methods of implementing it? If so, does it have the right to take action against other states that chose a different, less costly, method?

### Options

□ Consider measures pursuant to MEAs exceptions for the purpose of GATT Article XX (b) and (g). Several criteria must exist for the exception to be granted.

- The domestic measure must be:
  - directly linked in form and effect to the MEA. the wording precise and not hortatory
  - non-discriminatory
  - proportional and no more restrictive than required to meet the objective of the measure.
- The MEA must be:
  - widely endorsed by countries
  - have unambiguous objective and substantive requirements
  - open for signature by any country

### Scenario Three

*Keyword Outline: emissions trading, trade-related environmental measure*

Countries 'E' and 'F' are both Annex

I countries. Country 'F' is, for the purposes of the UNFCCC, considered to be an Economy in Transition (EIT) Party.

Country 'E' is a highly developed and industrialized country. It has invested much in an attempt to maximize the efficiency of its manufacturing and industrial sectors. It has, since the actions of OPEC in the Seventies, emphasized the need to maximise energy efficiency in order to reduce vulnerability to international oil markets. At Kyoto, Country 'E' agreed to a reduction target of 6%. As it has already undergone major modifications in an effort to increase manufacturing energy efficiency, most of the emission reduction will have to be achieved by improving its energy mix. It plans to shift towards the use of more hydro, wind, and alternative energy sources.

To stimulate investment, and make alternative energy sources more competitive domestically, Country 'E' decides to impose GHG emission limits on *dirty* energy production plants such as those based on the use of coal or oil. The emissions ceiling is set very low and Country 'E' fully expects that many of these plants will, in their attempt to locate the most cost effective means of achieving their reductions, purchase emission credits. These purchases will be made via the international emission trading market setup under the Kyoto Protocol.

Country 'E' has issued a controversial directive that encourages domestic plants to buy credits from countries that accepted *actual* targets under the Protocol and avoid those countries trading in *hot air*. The directive states that any credits purchased from countries trading in *hot air* will be discounted at a twenty per cent reduction of their emission credit value.

Country 'F', following its transition to a market economy, has experienced a steady decline in its manufacturing sector. This has caused its GHG emissions to drop far below their 1990 levels. Despite this trend, Country 'F' agreed, at Kyoto, only to the stabilization of its GHG emissions at 1990 levels. It justified this below average target on the basis of the overall flexibility offered to economies in transition. What this meant to

Country 'F' in real terms, was that it possessed a pre-existing surplus of emissions available for trade. To trade this surplus will not actually result in any real emission reductions as Country 'F' would not have created these emissions even if it had not planned to sell them on the open market for profit. Country 'F' is aware of Country 'E's decision to discriminate against countries alleged to be trading *hot air* and informs Country 'E' of its opposition to the policy.

Having no recourse to binding arbitration or effective dispute settlement under the Protocol, Country 'F' decides to refer the case to the WTO. Country 'F' puts forward the case that an emission is a *good* for the purposes of the GATT and that the Country 'F' policy constitutes overt and arbitrary discrimination which is not permitted under the principles of NT and MFN.

### *Issues and Outcomes*

Trade related environmental measures (TREMs) have generated the most concern amongst trade experts and environmentalists in terms of potential conflict with WTO rules. From the environmental perspective, concern stems from the possible interference that WTO provisions or conditions might impose on the TREM. This is despite the acknowledgment, by WTO officials, that it is the architects of MEAs that are probably in the best position to oversee the use of TREMs. From a trade perspective, TREMs are viewed with caution as their full impact is yet to be tested and their potential to interfere with trade remains a possibility. That no TREM related case has, so far, been brought before the WTO has only added to debate, speculation, and anxiety.

In reviewing TREMs, the WTO Committee on Trade and Environment (CTE) has often used for discussion an example of discrimination pursuant to an MEA, against a MEA non-signatory, concerning Parties that are both signatories to the WTO. It has been recognized that it is just such a case that might put the WTO in the unwanted position of being the only forum available to the non-Party to resolve the dispute.

There seems to be a marginally lower level of concern for trade discrimination on goods that are traded outside their environmental regime but also regulated by an MEA. Examples of such goods are hazardous wastes, endangered species, and ozone depleting substances (ODS). These are controlled by the Basel Convention, CITES and the Montreal Protocol, respectively. All of these agreements call for discrimination and the regulation of trade in goods, that prior to the MEA regime regulations, were openly traded with commercial value on international markets. In the case of the Montreal Protocol a desire not to interfere, inadvertently, with WTO rules led to the creation of a sub-group under the Ad Hoc Working Group of Legal and Technical Experts during Protocol negotiations. The sub-group considered the compatibility of the regulation of ozone depleting substances of the Protocol with the GATT. The group concluded that the two were compatible as the Protocol provisions would most likely be justifiable under GATT Article XX. At the time the WTO Committee on Trade and Environment did not exist and the issue of compatibility in this issue area was not the focus of as much concern as it is today.

The above case involving Country 'E' and 'F' presents a third scenario that raises an issue that has yet to be explored within MEAs. Its implications are not fully understood either by trade experts, or environmentalists. The distinction between this scenario and the first two is that the Kyoto Protocol effectively introduces a completely new product to be traded – certified emission credits (CEC). Prior to the Protocol, emissions had never been traded on international markets and this has raised fundamental questions about whether CECs should even come under the jurisdiction of the WTO given that they are inherently limited to the Kyoto Protocol.

In the absence of express rules limiting CEC related issues to the UNFCCC difficulties may arise because there is no legal barrier preventing Country 'F' from bringing the case before the WTO dispute settlement. The broad rules of the Dispute Settlement Understanding (DSU) apply to disputes pursuant to every imaginable good or service traded on the international market. Yet, if the WTO Dispute Settlement Body (DSB) were chosen as the forum in which emissions trading disputes were to be settled, as Scenario Three suggests, it would face several challenges of interpretation.

First, there would be the question of how to identify a CEC. Is it a good or a service? Some might argue that, as it has a physical aspect, it should be considered to be a good. It may, for example, be a by-product of the manufacturing process such as hazardous waste or used oil. No clear definition of a good has been provided within the GATT and, therefore, there is no solid basis from which to make an assessment. Alternatively, an argument could also be made that the emission is not the object of the trade. The object of the trade is, rather, the CEC permit, the right to emit. Under the General Agreement on Trade in Services (GATS), permits or credits would be considered a negotiable instrument and therefore a financial service. Whether a service or a good is important only to the point of establishing which WTO agreement applies; the GATS or GATT. For all intents and purposes however, both the GATS and the GATT work on similar principles.

After determining whether an emissions credit was a good or a service the DSB would then have to address the question of whether the WTO was the most appropriate dispute settlement forum. At this point the panel may rely upon past interpretations of international law as well as the Vienna Convention on the Law of Treaties. Under the provisions in the Vienna Convention it is stated that the principle of *lex specialis* should guide lawmakers in the event potential conflicts between treaties. The principle of *lex specialis* holds that more specialized agreements should prevail over more general agreements if both the states in question are party to both agreements. This could lead the panel to argue that the Kyoto Protocol is

a more specialized agreement, having created the emissions market. This would send a clear message that trading disputes must be resolved within the UNFCCC and not the WTO.

The key problem associated with using the international legal principle of *specialis* is its ambiguity. The term refers to the treaty that is the most explicit in terms of the subject matter. In regard to emission trading there are, arguably, two separate subjects involved. There are emissions and there is trade. If emissions were considered to be the subject of the treaty then the Kyoto Protocol would take legal precedence. If, on the other hand, trade is considered to be the subject, it is the WTO that would take precedence. The shortcomings associated with resorting to the principle of *lex specialis* stem from the fact that it was intended to deal with a different set of circumstances. It was intended to determine treaty compatibility between general treaties, often negotiated first, and the more specific follow-up treaties that elaborated on the generalities. It was not intended to deal with two specialized agreements, both of which could be argued to have the same subject matter.

If, in the case of Scenario Three, the WTO was considered the most relevant, the rules of NT, MFN and non-discrimination would apply and most likely lead to a ruling against the Country 'E'. Why? The origin of product can not be taken into consideration as a basis of discrimination. A CEC from a country not trading hot air is a like product with a CEC from a country that is trading hot air. Therefore Country 'E' must treat both products equally, and a 20% reduction of the value of the CEC from Country 'F' would be considered arbitrary discrimination.

### *Options*

- In the Kyoto Protocol explicitly define 'emissions' as outside the definition of either a service or a good for the purposes of the international trade rules. Further recognize that disputes arising in relation to emissions trading must be solved in the Kyoto protocol and according to WTO rules.
- Provide for an effective, mandatory and

binding dispute settlement system under the Kyoto Protocol for matters arising from disputes in conjunction with emissions trading, the Clean Development Mechanism (CDM) and the Joint Implementation (JI).



# 3

## The Inter-relationship between the Kyoto Protocol and the Proposed International Investment Regime

### Summary

Many concerns regarding the compatibility of the Kyoto Protocol and the proposed multilateral agreement on investment are similar to the concerns regarding free trade. Again, the issues relate to appropriate discrimination and the protection of member's rights and, again, compatibility will depend upon how the Kyoto Mechanisms are defined and implemented. A fundamental distinction arises between the two discussions, however, in that the various trade regimes are already well established and can be explored in minutiae. An investment regime is only now being proposed and, therefore, any discussion of its compatibility with Kyoto must remain both broad and hypothetical.

The overall objective of the proposed multilateral agreement on investment is consistent with the Kyoto Protocol. The potential overlap between agreements would, in fact, be quite substantial as both seek to influence the pattern of investment from developed to developing countries. The clean development mechanism, in particular, will be affected by both agreements. Investors in CDM projects will have rights and obligations under both the Protocol and the MAI.

As with efforts to protect free trade, the Kyoto Protocol has the potential to conflict with

efforts undertaken within the investment agreement to eliminate discrimination. The proposed investment agreement would prohibit both *defacto* and *dejure* discrimination by the host state between foreign and domestic investors, and between different foreign investors. The Protocol, however, encourages such discrimination if, and when, it enhances the effectiveness of the clean development mechanism. Similarly, the very manner in which the mechanism is to be coordinated is discriminatory in that investment opportunities will be limited to Annex I countries, and both non-complying and non-signatory countries will be disadvantaged. In addition, significant government intervention and discrimination at the project level is envisioned, which is exactly what the investment agreement seeks to limit, if not avoid.

A particularly complex issue relates to the possibility of both direct and indirect government expropriation of either the clean development mechanism project itself or rights to the emission credits generated by it. The multilateral agreement on investment would seek to protect investors from the risks of government expropriation or other detrimental changes in domestic legislation. The Protocol allows for significant host government intervention under certain circumstances and in defense of environmental objectives. Before it would be possible to establish how these two competing ambitions could be rendered compatible it would

first be necessary to clarify a number of issues relating to project oversight and ownership.

Many key aspects of the clean development mechanism have yet to be negotiated and its operational details have not been elaborated. It remains unclear as to which actor will own the rights to emission credits at which stage of the project timeline. Also, it has yet to be decided whether host governments will be allocated an automatic share of emission credits. These issues, along with a number of others, must be clarified before it is possible to even approach the issue of investor-versus-host country rights and responsibilities. Once they have been established negotiators will then be in a position to design a framework through which the sovereignty of the host country can be maintained and the rights of the project investors protected. This would incorporate the institutionalization of rights and responsibilities as well as the formulation of a system of compensation.

It will also be critical, given the significant amount of overlap between the flexibility mechanisms within the Protocol and the proposed multilateral agreement on investment, that the responsibilities and jurisdictions of the two are clearly delineated. It could, for example, be the case that the investor-state dispute settlement features outlined within the investment agreement could serve a dual function and fill the gaps that exist within the Protocol. What would become an issue in this case, would be the relationship between member and non-member rights and obligations in respect to each convention. Not all signatories to the proposed investment agreement will necessarily be signatories to the Protocol and visa versa.

### Scenario Four

*Key word Outline: Investor vs. State Dispute Settlement, direct expropriation, CDM environmental exceptions*

Country 'G' is an Annex I country that allows its domestic legal entities to participate in CDM projects. Cleanex Investments Inc. is a private brokerage firm in Country 'G' that specializes in CDM investments. These investments accrue CERs that Cleanex sells worldwide to industries

and Annex I States that have GHG emission reduction targets.

Under the terms of the CDM, finally agreed upon by the COP, Annex I CDM investors may have their right to participate in CDM projects suspended if they are proven to be out compliance with the Protocol. The provision is similar to Article 6.4, which prohibits the use of the emission reduction units towards the emission targets until the compliance question has been resolved.

Such a compliance question is raised by the Parties in relation to Country 'G's implementation of the Protocol and, as a result, Country 'G' is suspended from investing in CDM projects until it can comply with the Protocol.

*Cleanex* is engaged in the initial phase of a CDM project in Country 'H'. Country 'H', after learning of the Country 'G' suspension, orders the project closed and expropriates its assets. Country 'H' compensates *Cleanex* for the market value of investment expenditure thus far, but does not compensate *Cleanex* for the potential value of CERs that were expected to be produced by the project.

*Cleanex* presents two arguments to the State Investor dispute settlement mechanism of the Multilateral Investment Agreement, which has now come into force. The company argues that it is entitled to continue the project otherwise it could claim discrimination under the MFN and NT clauses of the MAI. It also files a second violation of the MAI claiming that it was not compensated for the potential value of the CERs that were expected to be generated by the project.

Country 'H' claims that it acted in accordance with the Kyoto Protocol provisions governing the CDM and questions the right of *Cleanex* to bring the dispute under the MAI. On the second matter, concerning the expropriation, Country 'H' argues that, as the project was only in its initial phase, it had not generated any CERs and therefore *Cleanex* had no valid claim to be compensated for the potential loss.



*Issues and Outcomes*

This scenario brings three different issues to light: whether the MAI dispute settlement mechanism is a legitimate forum through which to attempt to resolve CDM matters; whether Country 'H' has the authority to suspend *Cleanex's* right to implement the CDM project; and the question of expropriation and compensation for the potential value of the CERs.

The question of whether MAI dispute settlement would apply to a CDM investor highlights a useful example of the potential overlap, and possible coordination problems, between international treaties. Currently, under the FCCC there is no recognition of any international investment regime. This is the case despite the fact that the CDM could clearly be considered an investment for the purpose of the MAI or any other international investment regime. Under the proposed MAI, investment in a CDM project could be considered a right under contract, a debt, or a financial instrument.

In accordance with many of the terms used often in bilateral investment agreements (BIAs), an investment can mean every kind of investment including, inter alia, companies, contractual rights, intellectual property, permit licenses. Under the WTO the CDM could arguably be considered a trade-related investment measure or a service. As with the UNFCCC, however, none of these agreements explicitly recognize CDM investments in their provisions. As a consequence, no provision within any of the relevant agreements would prevent an investor from bringing a CDM dispute to either the MAI, or a BIA that contains a similar dispute mechanism.

In the case of the WTO this does not pose as great a problem as private investors (non-states) are not permitted to bring their disputes before it. The dispute settlement mechanisms within the proposed MAI allows, as do most BIAs, investors to bring disputes directly before the host state. In the context of *Scenario Four* the consequence of this is that even though Country 'G' has had its rights suspended it may not prohibit *Cleanex*, as an investor within its territory, from attempting

to defend its position through either the relevant BIA or the MAI. Whether the defense would be successful is another matter.

Under the MAI and BIAs the actions taken against *Cleanex* are, arguably, discriminatory and they violate the MFN and NT articles. The discrimination, however, is taken pursuant to an MEA and, like the WTO Article XX, the MAI provides exceptions for environmental purposes. Country 'H' would likely be granted an exception, if it made this argument against *Cleanex's* discrimination claim. In the event of a conflict with a BIA, most of these agreements settle disputes according to UNCITRAL arbitration rules. These rules would interpret a dispute first according to the obligations in the investment agreement or the respective contractual arrangements, in the case of no explicit rule or obligation the arbitrator would then turn to international agreements between the Parties as a basis for a decision. Since the provision to suspend CDM rights for non-compliance is agreed to by both Country 'G' and 'H' in the Kyoto Protocol it would likely rule that the Country 'H' decision to terminate the *Cleanex* project was warranted given that it is a legal entity within Country 'G's' jurisdiction.

The last issue raised in this scenario relates to the question of expropriation. Article 12.3, which provides the core of the CDM, is worded in such an ambiguous way that the question of ownership of potential CERs throughout the different stages of a CDM project is unclear. Ownership of the CERs is a crucial issue in terms of protecting investors from illegal expropriation. A host state's attempts to control or retain CERs, at particular points of the production process, could be legitimate or they may constitute illegal expropriation of an investment. Which is the case will depend on who owns the CERs at that point of the project.

If CDM emission reductions are treated in a manner consistent with the regime established for Annex I party emissions, ownership of CERs would be considered to be in the hands of the host government. Annex I countries are assigned emission allowances and they bear ultimate responsibility for any



emissions, or emission reductions, that occur within their territory. A country may devolve responsibility to the CDM investor for the purposes of the project but, ultimately, the responsibility for emissions and emission reductions remains with the government. If CERs are treated in this manner in relation to CDM projects in a Non-Annex I host country, the responsibility for the CERs and, ultimately, control over them, will lie with the host government. This would mean that host government actions affecting the CERs would not always, in all circumstances, be considered as expropriation.

Difficulties in terms of establishing exactly what sort of actions constitute expropriation may also occur in instances where the parties have determined that the host government will receive a share of the CERs generated within its territory. Such agreements must be elaborated in great detail, prior to the commencement of the CDM project, in order to avoid later confusion over differences in expectations.

The issue of expropriation is further complicated by the addition of an international compliance regime. Expropriation may occur when issues are raised in relation to the state of compliance of either the host country or the project investor. Host countries may, at the direction of a Kyoto Protocol body, be required to withhold credits or suspend the validity of a project.

At the core of the expropriation issue is the need to elaborate expectations and responsibilities, throughout the different stages of the project, before the project even begins.

### Options

- Since the Protocol is an agreement that provides for the possible participation of private parties, rules must be established that define and coordinate obligations, vis-à-vis, countries and the private parties.
- The rules governing international investment should be examined in the context of Kyoto Protocol Mechanisms. Potential incompatibilities should be identified and addressed by the Parties.

## Scenario Five

*Keyword Outline: proposed MAI, Indirect Expropriation, Additionality, Baselines.*

*Frigex* is a chemical company that produces refrigerants. It has headquarters in Country 'I'. Country 'I' is not a party to the FCCC, although it is a party to the newly adopted MAI. Country 'J' is a Non-Annex I Party to the Kyoto Protocol and a Party to the MAI.

*Frigex* has a small manufacturing plant in Country 'J' that produces Hydrofluorcarbon-134a (HFCs) for residential air conditioners and refrigeration units. This gas has an extremely high global warming potential, roughly 1300 times greater than CO<sub>2</sub>. *Frigex* is the only producer of HFC-134a in Country 'J'.

Country 'J' has passed legislation banning the use of HFC-134a as a refrigerant in all air conditioners and refrigeration units. The official statement given by the Country 'J' government is that the measure was taken in an effort to reduce GHG gases. *Frigex* learned, however, that the legislation was part of a requirement to meet an additionality baseline under the CDM of the Kyoto Protocol. A large manufacturer had proposed a CDM project that involved the construction of a large chemical plant in Country 'J'. The plant would supply Country 'J', and many of its neighboring countries, with CFC and HFC substitutes. The legislation banning the use of HFC-134a was part of Country 'J's' attempt to demonstrate that the proposed CDM investment would result in GHG reductions that would be additional to what would have occurred otherwise.

*Frigex*, after discovering the real motivation for the legislation, brings the issue to the MAI, protesting that the ban is an indirect expropriation, and calls for the immediate lifting of the legislation. Country 'J' refuses, stating that the legislation is necessary to protect its environment and is entirely appropriate under the stated objectives of the Kyoto Protocol.

#### *Issues and Outcomes*

*Scenario Five* deals with the controversial indirect expropriation clause proposed under the MAI negotiating text. A discussion of this clause, again, touches on the issue of potential coordination problems between two multilateral regimes. On the one hand, Country 'J's' legislation is designed to implement the Kyoto Protocol. On the other, the legislation creates a conflict under the MAI or, rather, it would create a conflict if an approach similar to this OECD approach were ever adopted.

If it were adopted, the MAI definition of expropriation would be broader than the current standard in other investment agreements. Traditionally, the term has only referred to discriminatory action or deliberate confiscation. Its definition has not included regulatory takings or state measures such as taxation and licensing. The MAI definition of expropriation does include regulatory takings. The MAI definition is based upon the NAFTA model and is much more expansive than the traditional interpretation. The MAI prohibits any state action that serves as an equivalent to nationalization or creeping expropriation. Similarly, any action that causes "loss or damage to the investor or the investment" would be considered a breach of agreement obligations.

The overall impact of the MAI is that it dramatically expands the rights of investors and places much broader obligations on host states. It has yet to be made clear, however, whether the MAI would require compensation for state regulations that have the potential to reduce profits or damage investments. Similar experiences with NAFTA suggest that such actions would be considered to be expropriatory and some form of compensation could be claimed.

The CDM will, under the MAI, be subject to the same regulations as any other international environmental regulation. It will come into conflict with the MAI if it provides the basis for facially neutral actions that have a disproportionate impact on foreign investors. This means that a strong host country regulatory framework created for the

regulation of CDM projects would be vulnerable to attack under the MAI.

The situation in this scenario represents a clear example of the potential for conflict between the MAI and the CDM. In an effort to meet the certification requirements for the CDM, the host country, Country 'J' is accused of breaching its commitments under the MAI.

For a CDM project to be certified it has to satisfy an additionality requirement. The host country has to prove that the project will result in emission reductions that would not have occurred otherwise. In order to prove this a baseline, or reference point, has to be established. The host country must indicate what would have happened had the project not gone ahead, in order to prove that the project will result in real emission reductions. Although it is not yet clear how these baselines will be established, they will be significant to the process of verifying emission reductions.

The host country may also be required to demonstrate that real reductions will occur by providing evidence that the CDM project is not being counteracted by the introduction of dirty technologies elsewhere. Countries may choose to do this by passing legislation that backs up the baseline. In this scenario, Country 'J' attempted to do this when it passed legislation banning HFCs. Country 'J' had to prove that the proposed CDM project, involving the manufacture of HFC and CFC substitutes, would not be undermined by the increased production of HFCs or CFCs elsewhere. To achieve this, it passed legislation banning the use of HFCs.

While Country 'J' may have satisfied its requirements under the Kyoto Protocol's CDM it put itself, arguably, in breach of the non-discriminatory obligations under the MAI. As Frigex is the only producer of HFC-134a already operating in Country 'J', it was the only company affected by the legislation. Frigex argued that the legislation was discriminatory and amounted to indirect appropriation.

The issues at stake here, in terms of determining what constitutes expropriation, are similar

to the difficulties within the GATT in terms of determining discrimination against like products. The issue comes down to how an exception can be made for environmental protection without creating a loophole that could be used to disguise other intentions.

### *Options*

- Potential conflicts with MEAs, such as the CDM, could be addressed through specific provisions on MEAs in a General Exception clause that would be applicable to the entire MAI, if it were ever adopted. Perhaps the best approach, is one similar to Article 104 of NAFTA which in effect grants supremacy to trade-related MEAs that are expressly annexed in the agreement. Similarly the MAI could explicitly recognize MEAs containing investment related provisions and exempt these provisions from MAI rules.

## 4

# The Kyoto Protocol, the Private Sector and Inter-linkages with International Contractual Regimes

### *Summary*

The private sector is envisioned as playing a significant role within the implementation of the flexibility mechanisms and the overall success of the Kyoto Protocol. This raises questions about whether the planned system of compliance procedures and dispute settlement are adequate to deal with the anticipated level of private sector involvement. This is especially the case given the large sums of money that will be involved, the range of actors involved, and the role played by market forces. While the proposed compliance and dispute settlement mechanisms may be adequate to assure the overall success of the Protocol, some form of subsystem might be necessary to ensure success at the market mechanism level. This subsystem could be based upon a model provided by existing private international contractual regimes that include their own arbitration and conflict resolution mechanisms.

If the decision is made to utilize private contractual regimes within the operation of the flexibility mechanisms it would generate an entirely new round of questions that would need to be addressed. A decision would have to be made in terms of the types of contracts that would be most appropriate. Would a standardized contract for each of the three mechanisms be effective if they allowed for modifications to accommodate

the specific requirements of each project? Or, will the projects involved be so diverse that an all-encompassing standard format would be impossible to formulate? If a number of different contract formats are necessary, which ones would be best suited to which type of project?

The clean development mechanism possibly offers the greatest contractual challenge simply in terms of the range of issues that must be incorporated. A number of different types of contracts could be suitable including; intergovernmental cooperation agreements, concession contracts, build-operate-and transfer project contracts, joint venture agreements, risk service contracts offers. A number of other types of contracts may be suitable for the two other flexibility mechanisms. The key to the success with any of the contracts depends upon an identification of the specific advantages and disadvantages offered in terms of minimising any potential ambiguities.

The question of which type of contractual arrangements are deemed to be the most suitable will probably not be as relevant to the success of the mechanisms as the specific substance of the contracts. It is crucial that several core requirements be met and meticulous contractual standards adopted. The core challenge then is to locate, or design, effective contracts that meet these standards without destroying the very flexibility that makes

the market based mechanisms so attractive.

There are various other legal entities that may have a significant role to play in the implementation of the flexibility mechanisms. Many existing multilateral institutions could play the role of an intermediary in the operation of the mechanisms and also act in a monitoring capacity to ensure implementation standards. Development banks, for example, could serve as brokers between the buyers and sellers of emission reductions, assist developing countries with CDM projects, and help match potential investors with appropriate projects. Other multilateral institutions could play a similar role at either a global or a regional level. Various non-government organizations could also play an important role particularly in relation to verification and monitoring issues and the protection of developing country rights and interests.

### Scenario Six

*Keyword Outline: Private Legal Party vs. Non-Annex Party, CDM Project, international contractual regimes, standardized CDM contractual provisions.*

Country 'K' is an Annex I signatory to the Kyoto Protocol. Under the Protocol it has agreed to reduce its GHG emissions by 5% of their 1990 levels before the end of the first commitment period. Country 'K' assigns part of its reduction obligations to large upstream scale companies by imposing maximum emission limits.

Energex is a large utility company faced with the prospect of complying with Country 'K's domestic regulations. After considering its options, Energex decides that the most cost-effective means to meeting the regulation is either investing in cleaner technology, or using one of the Kyoto mechanisms. It is currently in the middle of twenty-year investment cycle, mostly involving investments in energy plants, and cleaner technology is not con-

sidered to be a cost-effective option at this time. As a consequence, Energex makes a decision to utilize the Kyoto flexibility mechanisms.

From the perspective of Energex, the CDM is a particularly attractive mechanism as it would give the company a chance to implement one of its current research and development projects. It would be prohibitively expensive for Energex to put its solar turbine project into service in its own country. For this reason, Energex approaches Country 'L' with a proposal to construct an energy plant using its solar turbine technology. The proposal is accepted by Country 'L' and the project is certified by the Executive Board of the CDM. The plant will benefit Energex in that it will receive CERs and will benefit Country 'L' through the provision of an environmentally cleaner technology.

Energex and Country 'L' enter into a standard Build Operate and Transfer (BOT) contract. Under the agreement Energex agrees to build the utility plant and operate it for a period of two years. The two-year period will be used to ensure the project's operational performance. The propriety rights will then be transferred to Country 'L'. As is common in international investment contracts, detailed arrangements are made within the contractual agreement for dispute settlement, liability, confidentiality of intellectual property and, even, taxation. The details concerning CERs, monitoring, reporting, and the form, or method, of the transfer of technology are given little attention. This is not surprising given that these types of issues are new and there has been little experience gained in terms of running CDM projects. Furthermore, there



were no standard contractual guidelines or mandatory provisions issued either by the Executive Board or by either country.

*Energex* constructs the plant and operates it during the initial two-year phase with few problems. During the transfer, and the subsequent period in which it is operated by Country 'L', the project is plagued with problems. During the transfer period there are disputes concerning the transfer of the technology. Country 'L' argues that it believed the project would involve more than just the construction of a utility plant. Country 'L' sought the adequate training of skilled personnel and the transfer of relevant technology and know-how so that it could construct, or refit, other plants within its territory. *Energex*, however, is keenly aware of the value of the technology and is very protective in terms of providing access to it. The company is not willing to cooperate any more than it is required to. It is reticent to provide the knowledge necessary to recreate the technology or the improvements it has made since the construction of the plant.

Following the transfer of ownership to Country 'L' problems arise in determining the actual CER as the monitoring equipment has not been maintained adequately. Also, the operational entities Country 'L' contracted to run the plant have failed to meet several reporting requirements to the Executive Board. As a result the Board determines that the plant will fall short of the originally anticipated emissions reductions. As a consequence, *Energex* will lose valuable CERs. In addition, as the end of the first commitment period is approaching, the company will have to find its CERs from an alternative source. It acquires its CERs through, what turn out to be, more costly measures such as emissions trading in an attempt to meet its domestic GHG reduction obligations. *Energex*, unwilling to shoulder the entire burden of the additional expenses, begins proceedings under the dispute settlement clause of the BOT agreement. In an attempt to recuperate its losses, *Energex*, accuses Country 'L' of having liability in the matter.

### *Issues and Outcomes*

This scenario highlights a number of important issues regarding the complexity of responsibilities and interdependence between the potential actors involved in a CDM transaction. The scenario is a simplification in that several other entities and relationships would be involved if the case occurred in the real world. There would be the involvement of regional development banks or other financiers, sub-contractors and third parties, and insurance companies. For the purposes of this analysis, however, the simple relationship depicted here will suffice.

One important issue demonstrated in the scenario is the potential problem that could arise if the objectives of the CDM are not clearly identified and provided for in the contract. The CDM has three dimensions; it is a form of investment, it is transfer of technology, and it incorporates environmental objectives set by the Kyoto Protocol. In the first two instances, a significant level of experience has been gained in terms of the governing of investments and the transfer of technology over sovereign borders. Several international investment contracts, such as the BOT or the concession contract, include standard clauses able to deal, fairly succinctly, with the first two elements. They provide sufficient clarity to resolve disputes if a misunderstanding related to respective obligations arises among the parties.

The third element, the environment, is an untested factor in the private contractual regime. Regardless of the type of contract, whether it is concessionaire, intergovernmental, service, or joint venture, it will have to be modified so as to provide for the objectives of the Kyoto Protocol. It could be argued that environmental obligations would best be defined by environmental experts. To ensure that environmental obligations are met adequately, therefore, the relevant guidelines should be created, or standard clauses made mandatory, by the Executive Board. These clauses might include *inter alia* the determination of the share of CER generated from the project, monitoring responsibilities, liability issues, as well as dispute settlement and its relationship to the Protocol's dispute settlement provision (DSP).

It could be argued that it is the responsibility of the investor or the hosts to ensure the Protocol's obligations are met. To some this would be more attractive as it would mean fewer requirements and fewer transaction costs for the Protocol. The difficulty here lies in the complexity of the web of interdependent relationships involved. Each hinges on the other and only at the end of the process is a country able to meet the necessary percentage of reductions committed to under the Protocol. If even one of these relationships breaks down, it may serve to jeopardize the remaining relationships. This could eventually lead to a circumstance in which it is the environment that suffers. By synergizing existing contractual structures for private and public investment with standard provisions based on the requirements of the CDM, a strong contractual framework will emerge that can ensure balance and stability between the interdependent actors.

### Options

- Consider the adoption of a standardized agreement, mandatory clauses or strict guidelines so as to create strong contractual arrangements between Parties involved in CDM projects. Key standardization should include:
- Full conformity with the requirements of the UNFCCC, the Kyoto Protocol and any subsequent agreement relating to the CDM. In particular, the contract should define the emissions reduced (CERs); how they should be measured, verified, certified and shared between the contract parties; how the project stimulates sustainable development; liability arrangements in the event that the project fails to deliver the contracted CERs.
- Equity or fairness and transparency in apportioning rights and obligations between the parties. This may involve "affirmative action" to counteract unequal development and compensate for the structural weaknesses of developing country party;
- Unambiguous stating of terms, which

should include *modus operandi* for implementation and enforcement, financial mechanism, dispute settlement, liability and compensation for damages or failure of the undertaking;

- The principle of both host and home state co-responsibility for international economic and environmental co-operation.

### Scenario Seven

*Keyword Outline: CDM reforestation project, Intergovernmental contract, UNCITRAL, ICSID, Non-compliance, Dispute Settlement, force majeure.*

Country 'M' is a developed country with a 4% commitment under Annex B of the Kyoto Protocol. Part of its implementation strategy is to participate in the CDM, at the governmental level, with a partner developing country. It enters into an agreement with Country 'N' to finance a reforestation project that would result in the sequestration of carbon and contribute to a reduction in the greenhouse effect. It is agreed that the construction and management of the project would be carried out by Country 'N' and paid for by Country 'M'.

The Executive Board certifies the project and the projected CER are determined. In accordance with the Kyoto Protocol, part proceeds from the certified project will be contributed to a fund set up to assist developing countries adversely affected by climate change. A part of the proceeds will also go to the Executive Board and Country 'N' for administering the project.

Near the end of the first commitment period, fires spread from neighboring areas and wipe out the reforestation project. The fires were set by locals clearing forest to create agricultural croplands.

Country 'M' is placed in a difficult situation. As it is nearing the end of the commitment period Country 'M' was depending upon the CERs to meet its Annex B target, without the CER it will fall short. The only alternative at this late stage

is to buy CECs on the emissions trading market. This will be much more expensive at this point in time as a high demand as been created by the many Annex I countries struggling to meet their obligations.

Country 'M', faced with these circumstances, accuses Country 'N' with negligence in relation to the fires. Country 'M' argues a lack of due diligence in terms of; creating regulations adequate to restrict fire-clearing, in terms of providing proper monitoring, and in terms of establishing preparations adequate to combat and prevent such fires in the project area. Country 'M' demands reparations equal to the loss in potential CERs and the amount equal to the sum above the market value of the CECs it had to purchase in order to meet its reduction commitment.

Country 'M' raises the dispute under Article 14 of the Convention. It also decides to withhold any project proceeds intended for the fund for Countries adversely affected by climate, for the Executive Board, and for Country 'N' in return for administrating the project.

Country 'N' contests Country 'M's version of the causes of the fire and argues it was a case of *force majeure* and that it was, therefore, not liable for the project or the value of the CERs. It also contends that it exercised due diligence in preventing the possibility of fires in the area. It demands that Country 'M' pay its administrative fees and drop any contention of restitution. Under the multilateral consultative process of Article 13, Country 'N' raises the question of non-compliance in respect to Country 'M's decision to withhold proceeds for climate change fund and the administrative fees for the project.

#### *Issues and Outcomes*

This scenario does not allow for the mitigating impact of diplomacy, nor the potential for the informal negotiation of solutions. It does, nonetheless, highlight the types of disputes that may arise in relation to the implementation of the Kyoto mechanisms as well as the need to ensure that mechanisms exist that are capable of resolving them.

As they stand, the Protocol's dispute settlement provision and proposed non-compliance mechanism (MCP) are ill equipped to deal with a situation such as presented in this scenario. The proposed MCP is a preventative mechanism that is expected to be put into place to provide advice, understanding and technical assistance in the event of implementation problems. It might also be used to prevent disputes. It is not adequate in terms of resolving the types of disputes depicted in this scenario.

Article 18 of the Protocol allows for the potential development of a tougher mechanism for solving non-compliance problems. Although not yet negotiated, Article 18 could be used to address non-compliance in regard to the Kyoto Mechanisms. Questions relating to how a case of non-compliance may be triggered and the resulting consequences remain open.

Article 18 could serve as an appropriate and effective avenue for resolving the first element of the scenario; the non-payment of proceeds into the fund for countries adversely affected by climate change, and the non-payment of administrative dues. The case depicted in the scenario is complicated by the need to establish liability for the fire before any decision could be made in regard to the non-payment of proceeds. This being the case, how can such a complex dispute be resolved under the Convention?

The only DSP is Convention Article 14. It is similar in scope to the dispute settlement mechanism contained within various other international treaties. These have become relatively standard provisions despite the fact that they are almost never used. Under Article 14 of the Convention, disputes that arise between Parties are to be resolved first, and foremost, by "negotiation or any other peaceful means of their choice."

In the event that the dispute is not resolved through negotiation, the Parties may pursue either of two options. They may submit the dispute to compulsory arbitration. This includes the possible submission of the dispute to the International Court of Justice in cases where the disputing Parties



formally waived their sovereignty when depositing the Treaty. To date, no Party has made such a declaration. Alternatively, either one of the Parties may submit the dispute to a conciliation commission. This becomes an option if the dispute remains unresolved one year after either of the Parties has officially notified the other that a disagreement exists. The conciliation commission, which is to be set up in cooperation between the Secretariat and the Parties, can only make recommendations in good faith, it does not have the authority to issue obligatory requirements.

For obvious reasons the Convention's DSP would be ineffective in terms of solving a commercially oriented investment dispute such as depicted in *Scenario Six*. The DSP is not compulsory and thus Country 'M' would not be obliged to appear before any arbitrator, or the ICJ. The process is extremely slow, over a year would pass before a conciliation commission could even be created. Moreover, there is no binding judgement, the conciliation commission can only make recommendations.

A further drawback to the Convention DSP is that a CDM, JI or ET project could involve non-state actors. If this were the case, what would be the means of dispute settlement for such actors, as they would have no standing under the DSP?

There are several alternatives that could be considered to more effectively deal with the circumstances highlighted in this scenario. First, the Parties could attempt to negotiate an ancillary dispute settlement system, perhaps under Article 18, that is more attuned to resolving disputes under the CDM, JI and ET. This may, however, create an additional burden to an, already packed, negotiating agenda for dealing with the Kyoto mechanisms before COP6. A second option is to employ existing DSP under private international law. There are several tried and tested dispute settlement systems that the Parties could employ by simply plugging them into the agreement.

These regimes, such as *the International Convention the Settlement of Investment Dispute between States and National of States* 1965 (ICSID), or the *United Nations Commission on International*

*Trade Law* (UNCITRAL) arbitration rules. Standard investment agreements commonly resort to such systems and allow for binding arbitration to be submitted in a fairly short period, such as 90 days, if the dispute cannot not resolved. In accordance with the *1958 UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, such decisions could be final. A third option would be to allow the Parties to the dispute to access national courts, and in doing so, provide enforcement through existing domestic mechanisms. The choice of court would have to be determined contractually in the agreement between the countries, or according the conflict of laws.

To deal effectively with the type of conflict raised in this scenario the COP could make several recommendations through the Executive Board. It could recommend the employment of certain combinations contractual agreements. These could be amended according to guidelines, or standard clauses and the COP could require that each contract ensure a dispute settlement system, either through private contractual regimes, or domestic court systems.

### Options

- Within the Climate Change Convention or the Protocol create a dispute settlement system that can address the realities of the Kyoto mechanism. These realities include the commercial nature and large of

# 5

## Inter-relationship between the Kyoto Protocol and other Multilateral Regimes

### *Summary*

At an ecological level the objectives of the Kyoto Protocol are integrally linked with issues of forestry and biodiversity. The issue areas covered by the Protocol, the Convention on Biological Diversity, and other UNCED instruments overlap on many levels. This does not, however, necessarily translate to a high degree of compatibility between the relevant conventions. In fact, it is possible that the consequences of implementing certain types of JI and CDM projects from within the Protocol could work against the objectives of the forestry and biodiversity conventions. The core issue of concern in this matter is the use of terrestrial sinks to help mitigate climactic change.

Under the CDM, there is the possibility that developed countries may obtain emission credits for creating carbon sinks in developing countries. Depending on how they are undertaken such projects may, in fact, result in a net reduction in natural forestry and have a negative impact on biodiversity. There is nothing in the Climate Change Convention that either identifies, or prevents, detrimental practices. Nor, does the Convention incorporate an incentive for developing countries to preserve existing rain forests which, may be, the most effective type of terrestrial carbon sink. The reduction of old growth forest, in combination with an increase in plantations,

would result in a significant loss of biodiversity. In addition, plantations tend to be associated with an increase in the release of nitrous oxide as a result of the usage of nitrous-based fertilizers.

The solution that has been offered in an attempt to preserve existing rainforests as carbon sinks is indicative of the overall dilemma inherent within the issue of implementing the Protocol's flexibility mechanisms. The proposed solution would be to offer financial incentives, or compensation, to countries in an effort to motivate the preservation of rainforests. The issue of allocating a financial value to different environmental protection measures is a complex one. It is located at the greatest source difficulty in relation to the implementation of all of the flexibility mechanisms. It also causes the Protocol to shift even more deeply into the economic realm because it introduces immediate profit as a motivation for environmental protection. The challenge for implementation, then, is to ensure that the environment actually benefits from mechanism projects, such as the creation of terrestrial carbon sinks, and that they do not simply serve to increase the profit levels of the parties involved.

### **Scenario Eight**

*Keyword Outline: CDM, JI, Biodiversity, Desertification, Forestry Principles.*

Country 'O' is a small developing country with rich tropical forests and biological diversity. Much of the population is rural based and depend on agriculture as its main industry. The rate deforestation and loss of biodiversity due to forest conversion to croplands is a rapid trend in Country 'O' as cleared land, and logging give greater economic benefits than do standing forests.

Following the successful negotiation of the CDM, developing countries are encouraged to develop a portfolio of green house gas offsetting project proposals that will become, upon certification by the Executive Board, potential CDM projects.

Country 'O' welcomes the CDM opportunity to develop a portfolio. In order to encourage inputs from all the stakeholders in the sustainable development process, Country 'O' asks business, local and regional governments and civil society to suggest potential projects that they believe would be of the most benefit to Country 'O's sustainable development.

*Sustainable Horizons* is grass-roots based NGO in Country 'O', that wishes to participate in the process. It puts together a forest, land change, carbon sequestration project. The proposal is aimed at setting aside endangered forest areas that act as a buffer zone to one of the country's largest national parks. The project's objectives would protect and preserve the carbon deposits in existing forestlands, regenerate and reforest affected areas, encourage forest management practices such as reduced impact logging, and supervise harvesting and reforestation operations. The project would also encourage local communities to generate income from environmental tourism. The project is expected either sequester, or prevent the release of, over 15 million tons of carbon over a thirty year period.

*Sustainable Horizons* is quite sure that this is an ideal project. It is a synergistic approach to environmental protection that will promote the preservation and sequestration of GHGs and also have positive spin-offs for other MEAs such as *Desertification*, the *Forestry Principles* and

the *Biodiversity Convention*. The overwhelming majority of the world's terrestrial biodiversity is contained in forest ecosystems. The project seeks to encourage the sustainable use of existing, species rich, forest ecosystems. This will not only serve to protect biodiversity, it will discourage the types of land usage that lead to increased deforestation, degradation, and eventually desertification.

Unfortunately the project is rejected outright by Country 'O' officials, before it even has a chance to be considered by the Executive Board as a potentially certifiable project. Country 'O' officials remind *Sustainable Horizons* that, while their proposal is attractive, sequestration, land use, or forest conservation projects are not included as Article 12 CDM projects.

### *Issues and Outcomes*

It is unlikely that an established environmental NGO, grass-roots or not, would not have made itself aware of the limitations and expectations of CDM projects before putting together a proposal as elaborate as *Sustainable Horizon's*. Despite the narrative prerogative, the scenario highlights a significant issue in terms of creating synergies and capitalizing on inter-linkages between the FCCC and other MEAs. The key issue discussed within the context of this scenario relates to the eligibility of land-use projects in the CDM.

Debate over this issue centers on the wording of Article 12 of the Kyoto Protocol. The text refers to the reduction of greenhouse emissions, but says nothing about removals by sinks. This wording is very different than that of joint implementation (Article 6) which explicitly includes the possibility of projects that sequester carbon. There have been some questions of whether the difference was an intentional omission or simply inadvertence on the part of the negotiators. Whatever the initial reason for omitting terrestrial sink projects from the CDM, they have now become the focus of much debate. In discussions aimed at elaborating on the details of Article 12, several concerns have been raised in relation to the general role of land use projects and many have begun to question the value of including such projects

within the CDM.

For instance, there is concern that including forestry type projects will distract parties away from projects that tackle fossil fuel use, the main source of GHG emissions. Questions have also been raised concerning the possibility of developing accurate methodologies for estimating sequestration rates and baselines. Concerns have also been expressed in relation to the potential unintended negative consequences of promoting the conversion of existing forests into quick growth plantations. These issues are all valid but they do not necessarily represent an insurmountable barrier to the successful implementation of effective terrestrial sink projects within the CDM. Most of the potential difficulties and problems could be avoided through establishing a set of comprehensive guidelines and rules during current negotiations, or through the conduct of research into sound scientific methodologies.

Opportunities to capture synergies between the various Rio instruments would be lost if land-based projects, like the one presented in this scenario, are deemed ineligible for the CDM. Such projects can preserve biodiversity through maintaining habitat, natural forests, and sustainable reforestation. They help prevent potential desertification by preventing land degradation through topsoil and water retention, while at the same time creating 'real, measurable and long-term benefits' for the climate.

There is an inextricable link between land-based environmental issues and a stable climate. The World Bank estimates, for example, that drylands alone store about forty times the amount of carbon released yearly by anthropogenic activity. The same amount carbon that is currently stored in the atmosphere is stored in forests and vegetation. Two times that amount is stored in the soil. Combine these figures with deforestation rates of an estimated thirteen million hectares per year, as well as alarming rates of land-use and land-cover changes, and a very real incentive to open up the possibility of including terrestrial sequestration projects in the CDM becomes evident.

### Options

- Consider the inclusion of terrestrial sinks, and the conservation of threatened standing forests in the CDM.
- Clarification and codification of the rules and regulations guiding the effective implementation of terrestrial sequestration projects.
- Additional research into the scientific methods of estimating sequestration rates and baselines.

## Scenario Nine

*Keyword Outline: CDM, Biodiversity, Inter-linkages, Environmental Impact Assessments, Monitoring and Reporting.*

Country 'P' is Annex I Party to the Kyoto Protocol. It has agreed to carry out a joint implementation project with Country 'Q', an Annex I party that has signed on to the Protocol as an economy in transition. Both Parties agree on a reforestation project on a track of land that had been clear cut a decade earlier and not replanted. The project is expected to generate CERs equivalent to 500,000 tons of carbon over a fifteen-year period. Country 'P' plans to use the CER to assist it in reaching its emission reduction targets it committed to under the Protocol. Country 'P' hires a domestic professional forestry management company, called *Forestex*, to implement the project. Country 'Q' agrees with the appointment as Country 'P' has agreed to pay *Forestex's* fees.

The emissions reduction investment is to be implemented as early as possible as Country 'P' is anxious to accrue credits from the project in the first commitment period. *Forestex* plants a quick growth plantation with only limited variety of species.

Eight years later the trees on the plantation have matured to the point where the two countries agree that enough carbon has been sequestered to justify the certification of the project. Country 'P' engages a designated operational entity to evaluate the project and measure the carbon equivalent

that has been removed from the atmosphere by the trees. The operational entity carries out the evaluation. It is surprised at how fast the trees have grown, and calculates that the project has yielded a very successful 100,000 tons of carbon equivalent. Country 'P' submits the evaluation to the administrative authority, the reductions are registered, and Country 'P' is issued the relevant CERs.

The following year an NGO called *Green Earth* decides to carry out a study on the success of various joint implementation projects that have already started to accrue CERs. It selects several case sites, including the plantation sponsored by Country 'P'.

In the study, *Green Earth* discovers some disturbing facts concerning the Country 'P' project. First, suspicious of the extremely high growth rates of the trees, *Green Earth* takes a number of soil samples and discovers that high concentrations of nitrous oxide fertilizers have been used. These fertilizers are, themselves, sources of GHG emissions. Their use would have, to a certain extent, offset the amount of carbon sequestration for which the project had been certified. *Green Earth* also discovered that the run-off from the project had washed high concentrations of the fertilizer into local lakes and streams. This had caused certain types of seaweed to grow at unnatural rates. The overabundance of seaweed was beginning to strangle other types of aquatic growth and was interfering with the spawning grounds of the trout population.

The NGO investigators also noted that tree types varied only slightly and that the lack of species diversity effectively equated to the creation of a monoculture plantation. This not only rendered the plantation vulnerable to disease it also made it vulnerable to market fluctuations, if and when, Country 'Q' chose to end the JI project and harvest the trees for their wood. In addition, the types of trees planted were not native to the area and, as result, a number of endogenous species would not return to the plantation.

Having found these results very disturbing, *Green Earth* releases its findings to the press. Country 'P' responds by issuing its own statement

to the effect that the project had complied with the guidelines set for JI and had been certified by an independent source.

### *Issues and Outcomes*

This scenario highlights several issues that may become serious problems once the JI becomes operational. One of the key issues relates to project criteria. It is stated in Article 6.2 that implementation guidelines, including those for verification and reporting, must be established either at the COP/MOP 1 of the Kyoto Protocol, or as soon as it is practicable afterwards. It is not yet known whether these guidelines will include a requirement for a thorough evaluation of the project in an attempt to identify weaknesses and contradictions that may have unforeseen consequences for the project or negative impacts on other MEAs.

In the above scenario, for example, biodiversity had been damaged and the local ecosystem altered by the overuse of nitrous oxide fertilizers. The very objective of the project was undermined by the fact the overuse of the fertilizer offset some of the CER accrued from the project. Apart from the collateral damage that these fertilizers can cause when misused they are a major source of GHG emissions. Nitrous oxide has a particularly high global warming potential and an atmospheric life-span of over one hundred years.

Moreover, the JI project in this scenario did not take into account the findings of various studies that have been undertaken concerning plantations and their impact on biodiversity and indigenous species communities. The 1995 UNEP *Biodiversity Assessment* found that 'artificially homogenous forests' contributes to biodiversity loss by 'simplifying the components of the ecosystem' such as the soil, and by the 'active suppression of competing species.' The FAO has noted that plantations are gradually being recognized as a less desirable alternative to natural forests because of the adverse impact they have on global biodiversity. The impact of plantations is often questionable at a social, cultural, and economic level as well. UNEP, IUCN and WRI have stated that all plantations should employ a patchwork, or a mixed habitat,



approach to land use. This would include native trees species and encourage wildlife, and it would provide for the livelihoods and living space of local communities.

What is demonstrated in this scenario is that stringent guidelines are required under Article 6. These must be aimed at eliminating, as much as is possible, the potential for forestation projects, or any other type, to have unintentionally negative environmental consequences. An effective solution may be to require that each project undergo independent environmental impact assessments. These could be financed by project sponsors, or by the administrative authority, prior to project approval. As part of the monitoring and reporting process, criteria could be developed that would not only examine project compliance in terms of the Kyoto Protocol, but also explore its compatibility with the objectives of other environmental regimes such as the Biodiversity Convention.

### *Options*

- The codification of strict project standards and guidelines that take account of the findings of past experiences and case studies.
- Independent environmental impact assessments prior to project approval.
- A broader mandate within the monitoring and reporting process that incorporates a concern for the objectives of other multilateral environmental agreements.



## 6

# Conclusions

This report has, at a practical level, demonstrated the critical need for a more synergistic approach to environmental policy making that was identified in *Report - Part One*. Effective implementation of the Kyoto Protocol will depend, fundamentally, upon the development of an integrated approach. This applies not only to the need for synergies between the different multilateral environmental agreements but also between the different international regimes such as trade and investment.

This study has also demonstrated the crucial need to draw lessons from existing attempts to implement and regulate potentially conflicting international agreements. Through the scenarios it has highlighted possible options that could maximize potential synergies between the Protocol, relevant international regimes, and other environmental agreements.

The report has identified, as a key issue to be considered, the need to promote synergies and preempt potential incompatibilities before they become problems. To succeed in this task, further research needs to be undertaken that not only focuses on identifying potential inconsistencies, but also on maximizing potential synergies.





## 7

## Endnotes

<sup>1</sup> See *Report of Working Group Party on Border Tax Adjustments*, BISD 18S/97(1972). See also *Superfund* Panel report regarding petroleum and certain imported substances, BISD 4S/136S (1988) par. 5.1.1.

<sup>2</sup> See Panel report, *Section 337* case, 7 November 1990, BISD 36S/345. *Thai Cigarettes* case, 7 November 1990, BISD 37S/200.

<sup>3</sup> *Ibid.*

<sup>4</sup> Appellate Body report, *Shrimp Turtle* case, WT/DS58/AB/R, 12 October 1998, p. 47, par. 127.

<sup>5</sup> Appellate Body report, *Reformulated Gasoline* case, WT/DS2/AB/R, 20 May 1996.

<sup>6</sup> The chapeau is the introductory paragraph to a set of related provisions.

<sup>7</sup> Panel report, *Tuna Dolphin I* case, 30 ILM 1594 (1991), par. 5.28.

<sup>8</sup> See Edmond Govern, *International Trade Regulation*, Globefield Press 1995, which points out that sanctions have been placed *inter alia* on Rhodesia in 1966 (Res. 232), South Africa in 1977 (Res. 418), Iraq in 1990, (Res. 661), Libya in 1992 (Res. 748), Serbia and Montenegro in 1993 (Res. 757) and Haiti in 1993 (Res. 841) all of which would be considered exception under Article XXI (c).

<sup>9</sup> The *hot air* issue arose out of COP3 because the GHG reduction targets were differentiated between parties through political negotiation instead of a common formula. This allowed some Annex 1 parties to have comparatively inflated targets to the actual reality of what they could achieve. How? Some former Soviet countries have experienced economic declines since 1990, the base year of the GHG reduction targets. Arguably this decline combined with the relatively low targets taken by these countries at Kyoto means that any reductions in these countries would be artificial.

<sup>10</sup> FCCC Article 4.6.

<sup>11</sup> See *Scenario Two*.

<sup>12</sup> Although CTE and Ministerial debates have expressed the same concern, the concern was first identified by the *Report by Ambassador Ukawa* (Japan), Chairman of the Group on Environmental Measures and International

Trade, to 49<sup>th</sup> Session of the Contracting Parties, L/7402.

<sup>13</sup> Duncan Brack, *International Trade and the Montreal Protocol*, The Royal Institute of International Affairs, 1996, p. 67.

<sup>14</sup> *Ibid.*, p. 68.

<sup>15</sup> See discussion in *Scenario One*.

<sup>16</sup> International investment regimes for the purposes of this scenario mean trade-related investment measures (TRIMs) under the GATT, Investment related parts of the GATS, bilateral and plurilateral investment agreements and the proposed MAI. It is worth noting that despite the decentralization of investment rules these agreements have very similar provisions and obligations.

<sup>17</sup> For the purposes of this discussion the BIA is based on the American model. See for example Treaty between the Government of the United States of America and the Government of the Republic of Mozambique concerning the Encouragement and Reciprocal of Investment. For other agreements see Organization of American States Compendium of Bilateral Investment Agreements <http://www.sice.oas.org/>.

<sup>18</sup> *Scenario Five* discusses the question of environmental exceptions in more detail.

<sup>19</sup> Since Country I is not party to the FCCC it is not a Party to the Kyoto Protocol.

<sup>20</sup> The assumption is made, as in *Scenario Four*, that the last version of the MAI negotiating text available (24 April 1998) is use for the purposes of the scenario.

<sup>21</sup> IPCC, *Climate Change 1995: The Science of Climate Change* (Cambridge, UK: Cambridge University Press, 1996), pp. 119 and 121.

<sup>22</sup> The following discussion draws heavily upon Jake Werksman and Claudia Santoro, "Investing in Sustainable Development: the Potential Interaction Between the Kyoto Protocol and a Multilateral Agreement on Investment", in W. Bradnee Chambers (Ed.) *Global Climate Governance: Inter-Linkages between the Kyoto*

*Protocol and other Multilateral Regimes*. UNU/IAS Monograph, Tokyo: UNU Press. 1998. pp. 59-74.

<sup>23</sup> Ian Brownlie, *Principles of Public International Law* (4 ed.) (Oxford: Clarendon Press, 1990) at 531-538.

<sup>24</sup> As is noted in Jake Werksman and Claudia Santoro, 1998, this case is analogous of the NAFTA challenge of a US-based company, Ethyl Corp against the Canadian government for enacting legislation to ban the import and interprovincial transport of the gasoline additive Methylcyclopentadienyl manganese tricarbonyl.

<sup>25</sup> Presently, four agreements are contained in the NAFTA Annex 104.1: (a) the Convention on International Trade in Endangered Species of Wild Fauna and Flora; (b) the Montreal Protocol Substances that Deplete the Ozone Layer (c) the Basel Convention on the Control of Trans-boundary Movements of Hazardous Wastes and their Disposal and (d) the Canada-United States and Mexico-United States agreements concerning the trans-boundary movement of hazardous waste. The Article further elaborates