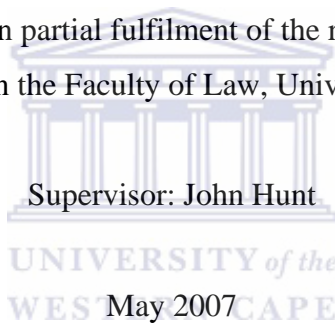


Speculating WTO Coverage and Classification of Emission Allowances Created and  
Generated by the Kyoto Protocol.

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## **Table of Acronyms**

AA	Assigned Amount
AAU	Assigned Amount Unit
CDM	Clean Development Mechanism
CER	Certified Emission Reductions
COP	Conference of the Parties
CH <sub>4</sub>	Methane
CO <sub>2</sub>	Carbon Dioxide
EC	European community
ERU	Emission Reduction Unit
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
GHG	Greenhouse Gas
HFC	Hydrofluorocarbon
ICJ	International Court of Justice
IET	International Emissions Trading
JI	Joint Implementation
MEA	Multilateral Environmental Agreement
MFN	Most Favoured Nation
NT	National Treatment
N <sub>2</sub> O	Nitrous Oxide
PFC	Perfluorocarbon

QELRC	Quantified Emissions Limitations and Reduction Commitments
SCM	Agreement on Subsidies and Countervailing Measures
SF6	Sulphur Hexafluoride
UNFCCC	United Nations framework convention on climate change.
US	United States
USEPA	The US Environmental Protection Agency
WTO	World Trade Organization



# **CHAPTER I**

## **1.1 Introduction and Problem Statement**

In the past century the world witnessed a dramatic increase in the population of the human race to the detriment of the world's environment and other biological forms of life. The seriousness of the situation is realized by more and more of the world's human population. The population increase was made possible by the advances made in the biologic sciences and supported by technological advances in all disciplines e.g. health, agriculture, communication etc. The advances were made affordable due to their financial and economic foundation. For many reasons e.g. political, social and financial pressure, foreign direct investment by developed countries, became acceptable for both the developed countries on the one side and the developing and third world countries on the other side of the balance. There was an increased demand for commodities which in general stimulated the growth of various sectors of the economy. Beneficiation and cheap production processes were some of the factors driving the demand for energy. Vast amounts of carbon dioxide and other Greenhouse Gases (GHGs) were produced by oil/fuel burning processes e.g. in industry vehicles, aeroplanes and coal power stations etc. Although industrialized nations are the main source of GHGs, the contribution of GHGs from developing and third world nations are growing at an alarming rate.

Research scientists claim to have proof that GHGs cause a rise in atmospheric temperature which will have a dangerous anthropogenic interference with the climate system. Most nations in the world perceive this finding to be fact. Dramatic changes in the atmospheric patterns and an increase in natural disasters with short and long term effects have been forecasted. There is a worldwide realization by all nations that everybody may be affected if this hypothesis proves to be correct.

Over the last decades, it was also realized that all human disciplines should be involved to stabilize the atmospheric temperature by controlling GHGs concentrations. When the

World Trade Organization (WTO) came into existence, it did not take into account the causes and consequences of a global climate change. To address the problem of GHG production, reduction of emissions had to be made more financially affordable. Financial instruments had to be created which had to be acceptable for trading purposes. The Kyoto Protocol provided for these financial instruments through the so called “flexible mechanisms”. Through the flexible mechanisms of the Kyoto Protocol, Assigned Amount Units, Emission Reduction Units and Certified Emission Reduction credits are generated which can be traded with internationally.

Many parties that ratified the Kyoto Protocol are also members of the World Trade Organization. This prompted speculation over possible conflicts between the Kyoto Protocol provisions and the WTO body of rules. As of yet there are no direct agreements or precedents of the WTO that define how the tradable units and credits of the Kyoto Protocol will be viewed. The WTO does not provide a framework for the classification of “Kyoto units”.

## 1.2 Significance and Scope of the study

The scope of the study is based on the views of different world authorities on this matter. The current legal status regarding the different opinions and arguments are also considered. This study will be limited to defining what allocation of allowances, unit and credits are and if these units and credits itself, as created by the Kyoto Protocol can be defined as goods, products, services or subsidies under the WTO body of rules. Domestic policies and measures such as “border tax adjustments” will fall outside the scope of this paper.

It is inevitably that conflict between these two regimes (the Kyoto Protocol and WTO) will arise and is therefore of importance to understand what the provisions of the Kyoto Protocol create. It will also assist policy makers and their advisors to understand the environmental threat and debate, and to make decisions accordingly in the absence of a WTO framework in this area.

### 1.3 Objectives of the study

A literature search and evaluation:

1. To analyze the provisions of the Kyoto Protocol and applicable WTO Agreements.
2. To assess possible interaction and conflict between these two regimes.
3. To analyze the classification of allocation of allowances, units and credits generated by the flexible mechanisms of the Kyoto Protocol under the applicable WTO Agreements.
4. To give recommendations to avoid conflict and how to incorporate environmental concerns.

### 1.4 Methodology

This study will be literature based focusing on the analysis of the relevant available literature. The research shall rely on both primary and secondary sources of literature. Among the primary sources are the Kyoto Protocol to the United Nations Framework Convention on Climate Change, the General Agreement on Tariffs and Trade, the General Agreement on Trade in Services and the Agreement on Subsidies and Countervailing Measures of the WTO, Conference of the Parties Decisions and Panel Decisions of the WTO. Secondary sources will include books, academic and scholarly articles, and various Internet sites consulted for background, relevant and up to date information on the subject matter.

### 1.5 Chapter Overview

This paper is divided into four chapters. Chapter one gives an introduction, general statement of the problem while referring to the significance and scope of the study. This chapter will also identify the objectives for conducting the research and methodology applied.

Chapter two will stipulate the current context within which the Kyoto Protocol is placed and will indicate how and why the WTO will be the choice of forum for disputes arising between parties to the Kyoto Protocol and members of the WTO.

Chapter three will analyze certain provisions of the Kyoto Protocol. Focus will be on explaining what allowances, units and credits are and how the Kyoto Protocol provides for international trading in these emission rights.

Chapter four will analyse and compare the provisions of the Kyoto Protocol and the WTO and speculate whether the allocation of allowances, units or credits will be defined as goods, products, services or subsidies. The conclusion and recommendations then follow.





## CHAPTER II

### 2.1 Introduction

Sustained economic growth and the maintenance of environmental viability are the two issues upon which it is imperative to agree. The world economy and the economies of most individual nations are interdependent on international trade. Currently most industrial economic activities create and emit a vast amount of anthropogenic gasses that substantially worsen what has been termed the greenhouse effect. This is an all-pervasive feature of our modern industrialised society. Subsequently, the planet's climate is slowly warming up, with potentially far reaching and devastating consequences. Global Climate Policy is a comprehensive and complex subject involving a number of academic disciplines.

For several decades scientists had warned that the emission of anthropogenic gases (greenhouse gases) should be reduced, but only in the 1980s did international pressure come to a head. In 1992 the United Nations addressed the issue for the first time during its Framework Convention on Climate Change (UNFCCC).<sup>1</sup> This was followed in 1997 by the Kyoto Protocol, a plan to use “market mechanisms” to address the reduction of greenhouse gas emissions (GHG) by industrialised countries with a focus on sustainable development.<sup>2</sup>

The consequences of reducing human-induced emission of GHGs, implies a change in the way parties to the Kyoto Protocol engage in activities cutting through a significant spectrum of society. The impact of limiting greenhouse gas emissions (GHGs) will modify key economic structures such as transport, agriculture, health, manufacturing, investment and, not least, the production of energy, all whose areas of interests cross international boundaries. Because it requires countries to modify and to streamline key infrastructures, investment systems, and the adaption of legal systems, the Kyoto

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<sup>1</sup>United Nations Framework Convention on Climate Change May 9, 1992, 1771 31 I.L.M. 849. Available at [http://unfccc.int/essential\\_background/convention/background/items/2853.php](http://unfccc.int/essential_background/convention/background/items/2853.php).

<sup>2</sup>Kyoto Protocol to United Nations Framework Convention on Climate Change, Dec. 11, 1997, 33 I.L.M 32. Available at [http://unfccc.int/kyoto\\_protocol/items/2830.php](http://unfccc.int/kyoto_protocol/items/2830.php). Last visited

Protocol will have an impact on economies and international trade relations unlike any other existing Multilateral Environmental Agreements (MEAs).

The Kyoto Protocol is unique because it represents the first global attempt by developed nations to collectively reduce the emission of a broad range of greenhouse gases but also represents the first MEA that has created a global market for trading in emissions.

“Never before has a MEA had the potential to impact so many sectors of the economy, so many economic interests and such high volumes of trade in products and services”.<sup>3</sup> This presents countries with difficult policy-related dilemmas regarding the integration of trade and environmental objectives. This will be the real challenge to policy makers.

## 2.1 WTO as Choice of Forum

The international discussions following the adoption of the Kyoto Protocol falls within the broader debate about the intersections and conflicts between international trade and environmental regimes. These discussions drew attention to the relationship between the emission trading system of the Kyoto Protocol and the legally binding rules embodied by the World Trade Organization (WTO)<sup>4</sup> governing international trade.

Article 2(v) of the Kyoto Protocol promotes the "progressive reduction or phasing out of market imperfections, fiscal incentives, tax and duty exemptions and subsidies in all greenhouse gas emitting sectors that run contrary to the objective of the Convention and application of market instruments",<sup>5</sup> and Article 2(3) of the Kyoto Protocol provides that parties “shall strive to implement policies and measures.....in such a way as to minimize adverse effects, including adverse effects of climate change, effects on international trade.....”.<sup>6</sup> The UNFCCC reflects similar language in several places.

This is in line with the WTO’s objective of “...substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade

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<sup>3</sup> Werksman, Jacob, Greenhouse Gas Emissions Trading and the WTO, 8 Rev, European Community and International Law, 1999, p 251,252.

<sup>4</sup> Marakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, The Legal Text: The Results of the Uruguay Round of Multilateral Trade Negotiations 2 (1999), 186 U.N.T.S. 154, 33 I.L.M. 1144 (1994).

<sup>5</sup> Supra note 2.

<sup>6</sup> Ibid.

relations”.<sup>7</sup> The Preamble to the Marrakesh Agreement “in return” states that parties in “their relations in the field of trade and economic endeavour should be conducted with a view of raising standards of living....while allowing for the optimal use of the world’s resources in accordance with the objective of sustainable developments, seeking both to protect and preserve the environment and to enhance the means of doing so in a manner consistent with their respective needs and concerns at different levels of economic development”.<sup>8</sup>

However, there are main ideological differences between the Kyoto Protocol and the WTO. The Kyoto Protocol’s main objective is to reduce (by implication restrictive laws unless greenhouse gas-producing factories change) GHGs through the facilitation of efficiently functioning international emission markets and facilitate sustainable development. The WTO’s main objectives are that of raising living standards, ensuring full employment, increase in real income and effective demand, sustainable development, growth in international trade and trade liberalization.

Another area of intersection between the two instruments concerns dispute settlement. This issue has been highlighted in the discourse concerning the refusal by the United States (US) to ratify the Kyoto Protocol. The US claims that Kyoto exempts 80 percent of the world from compliance, and would cause serious harm to the US economy. The United States stresses that Kyoto will not be able to effectively combat a global change in climate if developing countries like India and China are not subject to binding obligations relating to the reduction of greenhouse gas emissions.<sup>9</sup> As opposed to the US, the Kyoto Protocol has been approved by the European Community (EC), and has committed itself to meet its established emission reduction commitments.<sup>10</sup>

Disharmony has increased between the US and the EC. The US administration fears that the EC will employ WTO dispute settlement mechanisms to promote the Kyoto

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<sup>7</sup>Preamble of the Marrakesh Agreement, Supra note 4.

<sup>8</sup>Supra note 1.

<sup>9</sup> Carlane C. “The Kyoto Protocol and the WTO: Reconciling Tensions Between Free Trade and Environmental Objectives. *Colorado Journal of International Environmental Law*”, *Colorado Journal of International Environmental Law and Policy*, 17, Winter 2006, 45.

<sup>10</sup> Status of Ratification UNFCCC Status of Ratification. Available at <http://uunfccc.int/resource/conv/ratlist.pdf>

Protocol and to punish the United States for its refusal to ratify the Kyoto Protocol.<sup>11</sup> The dialogue between the US and the EC illustrates the probability that conflicts between the WTO and the Kyoto Protocol will arise in the future.

Many scholars question the WTO's ability to effectively address environmental issues. The argument being that the WTO is a trade liberalization institution, lacks expertise on environmental issues, is bias toward corporate interests and will apply trade principles to settle environmental disputes.

Regardless of whether the WTO is an appropriate forum, dialogue between the US and EC coupled with the fact that the preferred choice of forum for trade-environmental issues have often been the WTO, conflicts will most probably be referred to the WTO for settlement by the Dispute Settlement Body. Further, the WTO dispute settlement system is deemed to be attractive because of its compulsory and binding nature, right of appeal, strict implementation, enforcement procedures and "short timetables". It is also viewed as the one institution with the most "teeth".<sup>12</sup>

There are questions about whether and how the rights and obligations of the members of the WTO and the parties to the Kyoto Protocol may conflict. Of particular concern is whether provisions in the Kyoto Protocol, as well as government policies and business activities undertaken in keeping with those provisions, may conflict with the WTO non-discrimination principles of National Treatment and Most Favoured Nation treatment.

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<sup>11</sup> See e.g., Christopher C. Horner, "WTO to Face U.S.-E.U. Kyoto Dispute. Washington Times, Sept. 21, 2002. Available at <http://www.sepp.org/Archive/NewSEPP/WTO2FaceDisput-Horner.htm>.

<sup>12</sup>Supra note 5, page 49.

## **CHAPTER III**

### **3.1 Defining Global Warming in relation to the Greenhouse Effect**

Infra-red radiation represents the heat waves created from different sources e.g. the earth, the sun, but also very important, industrial and other human activities in an increasing trend as part of worldwide pollution. A balance is continually created by a change in the atmospheric temperature which is measured as degrees Celsius. Naturally heat is retained in the atmosphere by different mechanisms to make life possible on earth. Excessive or inadequate heat retention according to scientists may destroy life on earth as we know it. At present the atmospheric temperature is rising constantly.

The only dramatic change of all the known factors is the increased energy production, caused by human activities. According to science a number of relative lightweight chemicals are produced by humans and therefore industrial activity which has the chemical ability to absorb infra-red (heat) irradiation in the atmosphere. Due to their light weight they tend to rise to the upper atmosphere, and not only absorb, but prevents the infra-red irradiation of heat into space. Some of the gasses with heat retaining abilities have been identified and the 6 gasses referred to as GHGs are water vapour, carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), sulphur hexafluoride (SF<sub>6</sub>), hydrofluorocarbons (HFC's) and perfluorocarbons (PFC's). It should be remembered that other gasses with the same abilities exist, and may be added to the list. It has been calculated that a doubling in the concentration of GHG's, will reduce the rate at which planet Earth can shed energy into space by 2%. That is an equivalent of energy of 3 million tons of oil every minute. Scientists argue that human activity is the main factor changing the balance which has a negative impact on the planet. Something has to be done about it. "If emissions continue to grow at the current rates, it is almost certain that atmospheric levels of carbon monoxide will double from pre-industrial levels during the

21 st century. If no steps are taken to slow greenhouse gas emissions, it is quite possible that levels will triple by the year 2100”.<sup>13</sup>

### 3.2 The Kyoto Timeline:

- 21 March 1992 : United Nations Framework Convention on Climate Change into force.
- April 1995 : The 1<sup>ST</sup> Conference of Parties to the UNFCCC (COP 1) held in Geneva, Switzerland.<sup>14</sup>
- December 1997 : COP 3, held in Kyoto, Japan (The Kyoto Protocol’s place of birth)
- November 1998 : COP 4, held in Buenos Aires, Argentina (Buenos Aires Plan of Action).
- October 1999 : COP 5, held in Bonn, Germany.
- November 2000 : COP 6, held in The Hague, Netherlands.  
Which resumed in July 2001 in Bonn, Germany
- March 2001 : The United States withdraw from the Kyoto Protocol
- October 2001 : COP 7, held in Marrakesh, Morocco. “COP 7 provided the international community with the rulebook needed to implement JI and CDM projects, also referred to as “Marrakesh Accords”.
- October 2002 : COP 8, held in New Delhi, India (Delhi Declarations)
- December 2003 : COP 9, held in Milan, Italy
- 22 October 2004 : Russia Ratifies the Kyoto Protocol.
- December 2004 : COP 10, Buenos Aires, Argentina
- 16 February 2005 : Kyoto Protocol enters into Force 2005
- November 2006 : COP 12, Nairobi, Kenya

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<sup>13</sup> Beginners Guide to the Convention: “Understanding Climate Change: A Beginner’s Guide to the UN Framework Convention. Available at <http://unfccc.int/resource/beginner.html>

<sup>14</sup> Countries that are parties to the UNFCCC but not parties to the Kyoto Protocol can participate in the COP as observers but cannot make decisions. See <http://www.usinfo.state.gov/xarchives/display.html?p=washfile-english&y=2006&m=November&x=2006110614554811cnirellep0.3268701>

### 3.3 Introduction to the Kyoto Protocol

The United Nations Framework Convention on Climate Change (UNFCCC) was the forerunner to the Kyoto Protocol and was concluded in New York on 9 May 1992, it came into force on 21 March 1994.<sup>15</sup> The first limitation of the UNFCCC was that the goals did not bind parties, and the second, the objective of the UNFCCC was to stabilise rather than reduce greenhouse gas emissions, “at a level that would prevent dangerous anthropogenic interference with the climate system”.<sup>16</sup> It was for this reason that the Kyoto Protocol was negotiated and adopted at the third meeting of the Conference of Parties to the UNFCCC in Kyoto, Japan, which established legally binding emission targets for the reduction of greenhouse gases (GHGs).<sup>17</sup>

The COP will also serve as the MOP (Meeting of the Parties to the Kyoto Protocol). The Conference of the Parties (COP) is the “supreme body” of the UNFCCC Convention and decides on issues relating to the Kyoto Protocol. It is the highest decision making authority. It is an association of all the countries that are Parties to the UNFCCC and the Kyoto Protocol and meets on an annual basis, unless the parties decide otherwise.<sup>18</sup>

For the Kyoto Protocol to enter into force, 55 members representing 55 per cent of the total GHG emissions in 1990, had to ratify the Kyoto Protocol. Without Russia, Annex 1 ratifications would only represent 44 per cent of the total GHG emissions produced.<sup>19</sup> The Kyoto Protocol entered into force only after it was ratified by Russia. With Russia, parties to the Kyoto Protocol now calculate for 64 percent.<sup>20</sup>

Annex I parties to the Kyoto Protocol have committed themselves to achieving, between 2008-2012, a 5.2 per cent reduction in GHG emissions from the levels existing in 1990,

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<sup>15</sup> Available at [http://unfccc.int/essential\\_background/convention/background/items/2853.php](http://unfccc.int/essential_background/convention/background/items/2853.php)

<sup>16</sup> Supra note 1, article 2.

<sup>17</sup> Supra note 2.

<sup>18</sup> Grubb M., Vrolijk C. and Brack, D., “The Kyoto Protocol: A Guide and Assessment”, Royal Institute of International Affairs, 1999, Glossary, page xxvii. See also <http://unfccc.int/meetings/items/2654.php>.

<sup>19</sup> See [http://www.cseindia.org/programme/geg/cdm\\_timeline.htm](http://www.cseindia.org/programme/geg/cdm_timeline.htm)

<sup>20</sup> Status of ratification available at <http://maindb.unfccc.int/public/country.pl?group=Kyoto>

and is reflected in article 3 of the Kyoto Protocol.<sup>21</sup> It is still too early to gauge how successful the Protocol will be in terms of reducing greenhouse gas emissions in the 2008-2012 budget window. Nevertheless, it is the one multilateral policy tool that we possess with which to address the problem of global warming.

It will be costly for parties to limit GHGs to their respective commitment obligations and parties will face different degrees of costs in limiting GHG emissions. From an economic perspective it matters when and where reductions occur. Many economic analysis have been conducted and the overall conclusion reached was that the costs for achieving reduction of GHGs will be at its lowest through international emission trading instead of countries trying to reach their commitments on their own domestically. The flexibility mechanisms of the Kyoto Protocol provide parties with a degree of flexibility in choosing the time and place for reducing emissions. The flexible mechanisms of the Kyoto Protocol are International Emissions Trading (IET), Joint Implementation (JI) and the Clean Development Mechanism (CDM).<sup>22</sup>

### 3.4 Emissions Trading under Article 17 of the Kyoto Protocol

The concept of emissions trading is not completely new, but this relatively new concept is introduced by Article 17 of the Kyoto Protocol. It forms the basis for a global emissions trading system among Annex I parties with commitments inscribed in Annex B to the Kyoto Protocol. The basic feature of Emissions Trading as foreseen by the Kyoto Protocol, is an exchange of emission rights.

Article 17: “The Conference of the Parties shall define the relevant principles, modalities, rules and guidelines, in particular for verification, reporting and accountability for emissions trading. The Parties included in Annex B may participate in emissions

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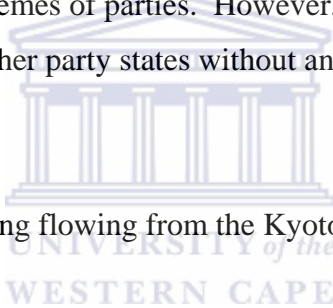
<sup>21</sup> “Annex I countries or parties” refers to developed countries with legally binding emissions limitation obligations as set out in Annex B of the Kyoto Protocol. Annex I countries are also sometimes refer to as “Annex B countries or parties”. “non Annex I countries or non Annex B countries” refers to developing countries without binding emissions limitation obligations but are parties to the Kyoto Protocol.

<sup>22</sup> The Marrakesh Accords provide the rule book for the flexibility mechanisms. Decision 15/CP.7 lays down the principles, nature and scope, decision 16/CP.7, 17/CP.7 and 18/CP.7 contains the operational provisions for JI, CDM and IET respectively. Decision 19/CP.7 provides for the rules for a system registry. Available at <http://unfccc.int/resource/docs/cop7/13a02.pdf>



trading for the purposes of fulfilling their commitments under Article 3. Any such trading shall be supplemental to domestic actions for the purpose of meeting quantified emission limitation and reduction commitments under that Article”.<sup>23</sup>

Although Article 17 itself is mostly referred to in the context of trading of AAU’s, the restriction to AAU’s can not be found in the text of Article 17 itself. The Annex to Decision 18 of the COP 7, states that “a Party included in Annex I with a commitment inscribed in Annex B is eligible to transfer and/or acquire ERUs, CERs, AAUs.”<sup>24</sup> Thus Article 17 include trade in ERUs and CERs. The Kyoto Protocol also does not explicitly state if private or legal entities can participate in emissions trading but participation of companies and other private entities is clearly desired.<sup>25</sup> Participation by entities in emissions trading allows for two possibilities to emerge. Some parties to the Kyoto Protocol will establish a domestic emissions trading scheme that will in turn integrate with other emission trading schemes of parties. However, some parties may choose to trade directly with entities of other party states without an established domestic emissions trading scheme.<sup>26</sup>



The two principle types of trading flowing from the Kyoto Protocol are:

1. Trading between parties who committed themselves to legally binding limits.

The Kyoto Protocol provides for three ways through its flexible mechanism through which parties with legally binding emission limits on GHG emissions may participate in emissions trading:<sup>27</sup>

- a) Trading in Assigned Amounts;
- b) Agreements entered into to meet their emission caps jointly in the form of Collective Targets; and

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<sup>23</sup>Supra note 2.

<sup>24</sup>Decision 18/CP.7, FCCC/CP/2001/13/Add.2, para 1. Report of the Conference of Parties on its Seventh Session, Held at Marrakesh from 29 October to 10 November 2001. Available at <http://unfccc.int/resource/docs/cop7/13a01.pdf>

<sup>25</sup>Buck M. and Verheyen R, “International Trade Law and Climate Change – A Positive Way Forward”, July 2001. Available at <http://library.fes.de/pdf-files/stabsabteilung/01052.pdf>

<sup>26</sup>The EU emissions trading scheme is considered to be the first “CO2 Trading Scheme” in the world and January 2005 marked the start of the EU emissions trading scheme. See [http://ec.europa.eu/environment/climat/emissions/citl\\_en.htm](http://ec.europa.eu/environment/climat/emissions/citl_en.htm)

<sup>27</sup> Annex I countries are also referred to as Annex B countries.

### c) Project Based Trading of Assigned Amounts

#### 2. Trading between countries with limits and countries without limits.

Here the Kyoto Protocol provides for trading through the so called Clean Development Mechanism (CDM), which is the third flexible mechanism incorporated into the Kyoto Protocol.

The three mechanisms share a common basis in the basic articles on commitments and read as follows:

- 3(10) “Any emission reduction units, or any part of an assigned amount, which a Party acquires from another Party in accordance with the provisions of Article 6 or of Article 17 shall be added to the assigned amount for the acquiring Party”.<sup>28</sup>
- 3(11) “Any emission reduction units, or any part of an assigned amount, which a Party transfers from another Party in accordance with the provisions of Article 6 or Article 17 shall be subtracted from the assigned amount for the acquiring Party”.<sup>29</sup>
- 3(12) “Any certified emission reductions which a Party acquires from another Party in accordance with the provisions of Article 12 shall be added to the assigned amount for the acquiring Party”.<sup>30</sup>

### 3.5. Trading between parties which have committed themselves to legally binding limits

#### a) Trading in Assigned Amounts.

The six greenhouses gases which fall within the scope of the protocol are: carbon dioxide (CO<sub>2</sub>), methane CH<sub>4</sub>, nitrous oxide (N<sub>2</sub>O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF<sub>6</sub>).<sup>31</sup> Each gas has a certain index due to the varying power to accelerate global warming. On the basis of this index each gas is translated into CO<sub>2</sub> equivalents, which are the base unit under the Kyoto Protocol.

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<sup>28</sup>Supra note 2.

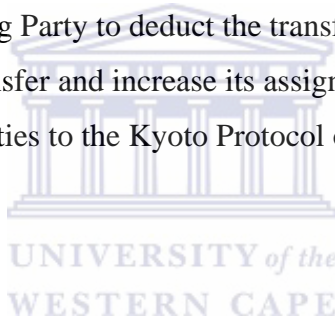
<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

<sup>31</sup> The Greenhouse Gases, Sectors and Sources are listed in Annex A of the Kyoto Protocol.

Each country is allowed to emit a certain amount of these base units called the Assigned Amount (AA).<sup>32</sup> Thus, AAs are the total amount of emissions that an Annex 1 party may emit over the commitment period and still meet its emission target, referred to as quantified emissions limitations and reduction commitments (QELRC),<sup>33</sup> as set out in Annex B of the Kyoto Protocol. These allowances when traded are referred to as Assigned Amount Units (AAUs) each of which is equal to one metric tonne of CO<sub>2</sub> equivalent.<sup>34</sup> All units and credits referred to in the Kyoto Protocol are equal to one metric tonne of CO<sub>2</sub>.

The emissions of Annex I parties may not exceed the AA, unless parties have acquired additional emission rights through the use of the flexible mechanisms. According to Articles 17, 3(10) and 3(11), parties through their governments can trade with these AAUs, but require a transferring Party to deduct the transfer from its AA before the acquiring party can add the transfer and increase its assigned amount.<sup>35</sup> Remaining AAU's can be sold to other parties to the Kyoto Protocol or be held for future fulfilment commitment periods.



#### b) Collective Targets.

Article 4 of the Kyoto Protocol permits Annex I parties to enter into agreements with other Annex B parties to meet their emissions target commitments jointly.<sup>36</sup> For example, the EU as a whole has decided to collectively reduce their emissions by 8% and will meet its target as a group. Emission commitments (AA) will be redistributed between countries while the collective total will be preserved. These arrangements may not be changed for the duration of the commitment period, thus the EU can not meet its commitment through the expansion to include other countries. Should countries not be in

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<sup>32</sup> Freestone D. (ed.) and Streck C. (ed.), "Legal aspects of Implementing the Kyoto Protocol Mechanisms: Making Kyoto Work", Oxford University Press, 2005, page 407.

<sup>33</sup> Ibid, page 10.

<sup>34</sup> Decision 11 of FCCC/KP/CMP/2005/Add.2, Report of the Conference of Parties on its Seventh Session, Held at Marrakesh from 29 October to 10 November 2001. Available at <http://unfccc.int/resource/docs/cop7/13a01.pdf>

<sup>35</sup> Article 17 is discussed on page

<sup>36</sup> Supra note 2.

compliance with their obligations, each is held individually responsible. In the case of the EU, the European Community is the legal entity representing the EU as a party to the Kyoto Protocol and countries will be joint and severally liable.<sup>37</sup>

### c) Project Based Trading of Assigned Amounts (Joint Implementation).

The economic concept was introduced by Norway and interestingly, it was the Bush administration of the US that drove the incorporation of the JI mechanism ultimately into the text of the Kyoto Protocol, and in the final negotiations.

Nowhere in the Kyoto Protocol is the term Joint Implementation explicitly referred to itself. Article 6 of the Kyoto Protocol, however laid down the basis of what is known as JI and is also known as the origin of CDM. Further, JI can only be implemented between Parties with QELRCs, and thus the integrity of the JI depends on the host countries ability to accurately establish and account for its AAU's.

Joint Implementation is based on the reduction or removal of GHG emissions through project based activities between Annex 1 parties, which generate credits named Emission Reduction Units (ERUs). These ERUs can be used by Annex I parties to meet part of a party's obligation under Article 3.<sup>38</sup>

An important requirement to a JI project, is that the emissions reductions that result from this project, should be additional to reductions that would have occurred in the absence of that investments. Joint Implementation does not allow additions to the overall amount of AAU's allocated under a country's "emissions budget". Hence, ERUs can only be used to partly fulfill the legally binding obligations under Article 3 of the Kyoto Protocol.<sup>39</sup>

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<sup>37</sup> Grubb M., Vrolijk C and Brack D., "The Kyoto Protocol: A Guide and Assessment", Royal Institute of International Affairs, 1999, page 122 - 123

<sup>38</sup> Supra note 2.

<sup>39</sup> Supra note 2, Article 6 (1)(d).

In contrast with AAUs, emission credits can be generated privately. It leaves Annex 1 parties with the discretion to authorize legal entities to trade<sup>40</sup> or participate in emissions trading through JI under government's authority.

Articles 3(10) and 3(11) specify that ERUs acquired will be added to a party's assigned amount, thus emission limits will be credited, and any ERU transferred to another party will be subtracted from the transferring parties, assigned amount. In other words, the credits referred to under Article 6 are actually assigned amount units renamed as ERUs, rather than a new unit. Participation in JI project activities implies the transfer of AAUs which have been converted to ERUs.

### 3.6 Trading Between Parties with legally binding emissions limits and those without

The rationale of the CDM is that projects that reduce emissions in non Annexure B parties will benefit the planet no matter where it takes place. This is especially applicable to fast developing countries like India and China.

Where Article 6 refers to Annex I countries transferring ERUs with other Annex I countries, Article 12, via its CDM allows Annex I countries to receive credits generated by investments in CDM projects that are based in developing countries without legally binding emission commitments (non-Annex B or non-Annex I countries). These credits are called Certified Emissions Reductions (CERs).

The CDM allows countries to fund specific eligible emission reduction projects that contribute to sustainable development in developing countries and then according to article 3(12), to credit the resulting emissions reductions credits against their obligations. Article 12 allows for the participation of public or private entities.<sup>41</sup> Both in CDM and JI projects the use of services such as engineers, architects, financial services etc. will be

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<sup>40</sup> Ibid. See article 6(3). Trade refers to the generation, transfer or acquisition of credits.

<sup>41</sup> Ibid, Article 12(9).

implied, from the host country and/or countries investing in projects in non Annex I countries. Clean Development Mechanism projects must be approved by both governments and the credits generated must be validated and verified as CERs.<sup>42</sup>

Each CER transferred under the CDM will entitle an Annex I party to an equivalent increase in emissions within its territory, while remaining in compliance. The CDM differs from JI in that there is no limit on the amount of CERs that can be generated. CERs can be used to increase Annex I countries emissions above its “emissions budget” provided that these reduction in emissions are additional to any that would have occurred in the absence of the certified project activity.<sup>43</sup> Thus for both CDM and JI an Annex I party must provide information showing that the use of the flexible mechanisms is supplemental to domestic action which constitutes a “significant element” of the efforts by Annex I countries.<sup>44</sup> Should an Annex I country be in compliance with its obligations, these credits can be sold or kept for future projects or commitment periods.

In conclusion, the following applies for all transboundary exchange of emissions permits (AAUs, ERUs and CERs) by governments and those initiated by approved entities authorized to participate in emissions trading under the provisions of the Kyoto Protocol. Currently the rules provide that each Annex I country must have a national registry in the form of an electronic database. Here the actual tradable units and credits held at any given time will be reflected. Each approved legal entity in the case of JI and each approved public or private entity according to CDM, must have an account reflecting the permits it holds. The accounts of each approved entity will be electronically linked to their country’s registry. The actual transfer closes or the “deal closes” when an entity records it in its own account. This recording will then immediately reflect in a party’s registry. Only parties to the Kyoto Protocol will have national registries and only approved entities will have accounts.<sup>45</sup>

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<sup>42</sup> Supra note 31, page 191 – 199.

<sup>43</sup> Ibid, Article 12(5)(c).

<sup>44</sup> See [http://unfccc.int/kyoto\\_protocol/mechanisms/items/1673.php](http://unfccc.int/kyoto_protocol/mechanisms/items/1673.php)

<sup>45</sup> COP 7, UNFCCC/CP/2001/13/Add.2, Annex. Available at <http://unfccc.int/resouce/docs/cop7/13a02.pdf>

In conclusion, all transfers will be made through the national registries of the authorizing Annex I party. A transfer of Kyoto Units by a legal entity in Country A to a legal entity in Country B is, at the same time, a transfer of such Kyoto Units by Country A to Country B. The total amount of Kyoto Units in the national account of Country A will be decreased by the number of Kyoto Units transferred by the legal entity. Thus, any transfer of units of credits between legal entities has to be mirrored by adding and subtracting an equivalent amount of AAUs in the national emissions registry of parties to the Kyoto Protocol in which private or legal entities engage.<sup>46</sup>



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<sup>46</sup> Ibid.

## CHAPTER IV

### 4.1 Speculating the coverage by WTO Agreements

Much research and negotiations have been devoted to the design and functioning of the Kyoto Protocols flexible mechanisms and hence questions arose about possible conflicts with international trade law. The questions addressed in the following section is whether emissions traders exchange goods, products or services and if emission allowance and the allocation thereof can be defined as subsidies by WTO definition. WTO Agreements relevant to this discussion are, the General Agreement on Tariffs and Trade (GATT),<sup>47</sup> the General Agreement in Trade in Services (GATS),<sup>48</sup> and the Agreement on Subsidies and Countervailing Measures to the GATT, (SCM and herein after called Subsidies Agreement).<sup>49</sup>

For the purpose of the analysis in this paper, the reader should note that, unless otherwise stated, the countries referred to are members of the World Trade Organization (WTO). Non-members would not be able to register a complaint against another country under the WTO system of trade rules if not a member.

WTO panels have consistently been hostile towards unilateral trade measures taken to protect the global commons, but have not yet had the occasion to rule on conflicts between the WTO and Kyoto.<sup>50</sup> Similarly, there are no current WTO Agreements that

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<sup>47</sup> General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, The Legal Text: The Results of th Uruguay Round of Multilateral Trade Negotiations 4 (1999), 1867 U.N.T.S.154, 33 I.L.M. 1144 (1994).

<sup>48</sup> General Agreement on Trade in Services, Apr 15, 1994, , Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, The Legal Text: The Results of th Uruguay Round of Multilateral Trade Negotiations 284 (1999), 1869 U.N.T.S.183, 33 I.L.M. 1167 (1994).

<sup>49</sup> General Agreement on Subsidies and Countervailing Measures, Apr 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, The Legal Text: The Results of th Uruguay Round of Multilateral Trade Negotiations 275 (1999), 1867 U.N.T.S. 14.

<sup>50</sup> Global commons are natural assets outside national jurisdiction such as oceans, air or the atmosphere, outer space etc. Global commons are not owned by a specific country but are the property of all countries. In terms of the Kyoto Protocol, for the holders of allowances, it does not create an entitlement in the atmosphere itself, as the state does not transfer ownership of a parcel of air. The assignment of quantified



defines emissions allowances<sup>51</sup> or international trade in emissions allowances coupled by the fact that the Kyoto Protocol represents the first opportunity for international emissions trading on such a large scale. Therefore, there is as of yet no direct relevant precedents to classify these instruments and the resulting units and credits. Only the WTO and bodies created by the WTO have the legal competence to interpret WTO Agreements. WTO panels are allowed to make findings on facts, and the WTO Ministerial Conference and General Council have the authority to adopt interpretations of WTO Agreements. This implies that this analysis is speculative in nature.

## 4.2 Goods or Products or Services

The fundamental principles as discussed below are the foundation of the multilateral trading system and runs throughout the whole body of agreements of the WTO. They are as follows:

- (a) Most Favoured Nation Principle (MFN) in Article I of the GATT: Countries may not discriminate between their trading partners. Any privilege granted to one member must be granted to other member states, thus members must be granted equal treatment. A member cannot treat a “like goods or products” of one member more favourably than “like goods or products” of another member.
- (b) National Treatment Principle (NT) of Article III of GATT: Foreign goods imported into a member state, should be treated in the same manner as domestically produced goods of a member state. Thus, once goods have entered a market, they must be treated equivalent to the “like” domestically produced goods or products.
- (c) Prohibition on import or export restrictions in Article XI of GATT: Quantitative restrictions on imports or exports is a measure that has the effect of preventing or

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emission reduction targets aims at regulating the use of the atmosphere, not the access to the atmosphere, it creates merely the right to release a certain amount of GHGs in the atmosphere for parties to the Kyoto Protocol. Supra note 32, p 3.

<sup>51</sup> Emission allowances refers to assigned amounts and the resulting AAUs and ERUs and CERs.

limiting imports or exports, such as a ban on an import of a particular product, quotas, import licenses etc.

These relative standards (MFN and NT) of the WTO “requires” a comparison of treatment between the “like goods, products or services” of countries, and the test is whether a measure directly or indirectly discriminates between “like goods, products or services”.<sup>52</sup> The absolute standards of the WTO, restricts member states the use of quantitative restrictions or limitations on the number or total value of imports or exports of goods or products, and the GATS on market access restrictions on the import or export of services. The Subsidies Agreement prohibits the use of subsidies or other forms of benefits that promote the export of domestically produced goods. Should one of these principles be a breach thereof it may be regarded as arbitrary or unjustifiable discrimination between countries where “like” conditions prevail.<sup>53</sup> These considerations are of relevance due to the fact that some parties to the Kyoto Protocol who are also members of the WTO, seek to restrict the trade in emission allowances, either on the basis of country of origin or quantitatively.

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What is a “like good or product”? In the Korea-Alcoholic Beverages case, the definition of like product is as follows:

““Like” products are a subset of directly competitive or substitutable products: all like products are, by definition, directly competitive or substitutable products, whereas not all “directly competitive or substitutable” products are “like”. While perfectly substitutable products fall within Article III:2, first sentence, imperfectly substitutable products can be assessed under Article III:2, second sentence”.<sup>54</sup>

Whether a product is a “like product” will be established on a case by case basis.

Applied, should units or credits be considered as “like goods or products or service”, the

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<sup>52</sup> Service suppliers are also included in the meaning of “service”.

<sup>53</sup> Werksman J., “Greenhouse Gas Emissions Trading and the WTO” in Chambers W. B. (ed.), “Inter-linkages: The Kyoto Protocol and the International Trade and Investment Regimes”, The United Nations University, 2001, p. 161.

<sup>54</sup> Korea – Texas on Alcoholic Beverages, Feb.17, 1999, adopted, as modified by the Appellate Body Report, WT/DS75/AB/R, WT/DS84/AB/R, DSR 1999:I, 44. Available at [http://www.wto.org/English/tratop\\_e/dispu\\_e/repertory\\_e/d1\\_e.htm](http://www.wto.org/English/tratop_e/dispu_e/repertory_e/d1_e.htm)

MFN and NT principle as well as the prohibition of quantitative restrictions may be implied should parties to the Kyoto Protocol, for example discriminate between AAUs, CERs or ERUs based on country of origin.

The GATT also does not define exactly what constitutes goods or products. Guidance to what members understand to be products can be taken from the “schedules of concessions”.<sup>55</sup> This suggests that products are seen as tangible goods. Further, GATT practice indicates that WTO members are likely to take a case-by-case approach to the question of whether a particular item is products or goods. Panel decisions do not create precedents to which future panels are binded, it does however provide us with a direction of trends followed.

Petsonk,<sup>56</sup> argues that although ERUs and CERs are created by the Kyoto Protocol and have a market value, they are intangible goods. The author then continues arguing that ERUs and CERs are specifically created by governments to meet their Kyoto Protocol commitments and are produced only through Kyoto Protocols flexible mechanism and function more as “transactable components of sovereign obligations”. The author then refers to AAUs and state that they exist only in consequence of, and through, the legally binding commitments of sovereign nations to limit GHG emissions and resemble goods or products even less.<sup>57</sup>

The author continues to argue that there is a distinction between goods and “transactable components of sovereign obligations” supported by GATT practice. This she supports by referring to the unadopted 1985 GATT Panel Report on “Canada - Measures Affecting the Sale of Gold Coins”,<sup>58</sup> (Gold Coin case). This dispute involved gold coins of South Africa (Krugrand) and Canada (Maple Leaf). The panel found that when these gold

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<sup>55</sup> All WTO members have a schedule of concessions (which usually consist of maximum tariff levels for trade in goods) which is either annexed to the Marrakesh Protocol to the GATT 1994 or to a Protocol of Accession. See [http://www.wto.org/English/tratop\\_e/schedules\\_e/goods\\_schedules\\_e.htm](http://www.wto.org/English/tratop_e/schedules_e/goods_schedules_e.htm)

<sup>56</sup> Petsonk, A., “The Kyoto Protocol and the WTO: Integrating Greenhouse Gas Emissions Allowance Trading into the Global Marketplace”, Duke Environmental Law and Policy, Fall 1999, p 185.

<sup>57</sup> Ibid, p.199.

<sup>58</sup> Canada – Measures Affecting the Sale of Gold Coins, GATT Panel Report, Sept. 17, 1985, unadopted, L/5863 p. 51. Available at [http://www.wto.org/gatt\\_docs/English/SULPDF/91160064.pdf](http://www.wto.org/gatt_docs/English/SULPDF/91160064.pdf)

coins were traded as “investment goods” they would be deemed “like products”, and subject to the GATT. The panel also noted that should these coins be utilized as “legal tender”, they are a means of payment and not covered by GATT. Petsonk then concludes and translates it into Kyoto language, that to the extent that AAUs, ERUs and CERs are a form of “legal tender” or “means of payment” in satisfaction of a Kyoto Protocol obligation, they would not be considered “products” or “goods”. Should they be treated as “investment goods”, the WTO rules would apply. This will imply that when a party to the Kyoto Protocol which is also a member of the WTO seek restitution via the WTO, the unadopted Gold Coin case may be invoked.

Weiser,<sup>59</sup> argues that the perception of goods being tangible has become more elastic referring to the European Court of Justice that ruled that electricity is a “good”. The author then redefines the concept of goods as being “something produced by labour, intellectual effort or natural process that can be transported from place to place and that possesses physical attributes”.<sup>60</sup> AAUs, ERUs and CERs may be paper certificates or only exist in electronic form and to this extend they may be things in a sense that a printed licence is a thing, but the holder of the certificate values this certificate or license for the rights it conveys. The author then defines a “permission” as a licence granted by the COP to the holder, to emit one tonne of carbon dioxide equivalent. Thus, permission by an authority to act in a certain way. While this “permission” is transferable, the “permission” itself has no physical attributes and is not produced by a production process. He then concludes that the credits or units created by the Kyoto Protocol, are a license that confers a right, a future right to pollute and that a licence is not a good and would therefore probably not fall under GATT coverage.<sup>61</sup>

Wemaere and Streck,<sup>62</sup> argue that the phrase “emissions trading” is not entirely correct because emissions are not traded, emission rights are. The learned authors define an

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<sup>59</sup> Weiser, G., “Frontiers in trade: the clean development mechanism and the general agreement on trade in service”, *International Journal of Global Environmental Issues*, Vol. 2. Nos3/4, 2002.

<sup>60</sup> *Ibid*, p. 294.

<sup>61</sup> *Ibid*, p. 295.

<sup>62</sup> Freestone D. (ed.) and Streck C. (ed.), “Legal Aspects of Implementing the Kyoto Protocol Mechanisms: Making Kyoto Work”, Oxford University Press, 2005, p. 47.

emission right as the right to emit a certain quantity of a specified substance during a defined period of time. The authors conclude that emission allowances or emission rights are at core “certificates” whatever their legal nature and the GATT do not cover the category of certificates. Therefore it will not be seen as goods or products.<sup>63</sup>

Werksman,<sup>64</sup> argues that because emissions allowances will be traded internationally and will have a market value, emissions allowances can be characterized as “commodities”. The author also states that the extension of the scope of domestic and financial markets incorporates now more “non-tangible” financial instruments, but he then continues arguing that there is no evidence that WTO members have an understanding of what a product is or that the WTO will even expand the definition of product.<sup>65</sup>

Claims under the GATS will most likely arise on allegations that the CDM projects and resulting CERs create services that are tradable. The potential coverage of GATS is broad and extends to services in all sectors but excludes services supplied in the exercise of governmental authority. The GATS also does not define what a service is and here guidance can be taken from the commitments and exemptions members have negotiated in each country’s schedule of commitments. The obligation each member has undertaken is set out in its own schedule.<sup>66</sup>

The MFN and NT principles are fundamental to the GATS as it is to the GATT, but it is applied differently. Referring to the MFN principle as set out in Article II of GATS, WTO members had a once-off opportunity to exempt from the coverage of GATS certain measures that provided more favourable treatment to identified countries. The exemptions were granted for up to ten years from the time the GATS agreement entered into force. The exemptions appear as part of the Annex to article II of GATS. With regard to the NT as set out in Article XVII and market access as set out in XVI of GATS,

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<sup>63</sup> Ibid, p.47.

<sup>64</sup> Supra note 53.

<sup>65</sup> Supra note 50, p. 166.

<sup>66</sup> These schedules of commitments are set out in the National Schedules to the GATS. There is a National Schedule for each WTO member. See “An Introduction to the GATS”, WTO Secretariate, Oct. 1999. Available at [http://www.wto.org/english/tratop\\_e/serv\\_e/cbt\\_course\\_e/signin\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/cbt_course_e/signin_e.htm)

WTO members can exempt certain services or service sectors from its application. Countries have identified certain service sectors, in a schedule of commitments to the GATS, to be subjected to WTO rules. Thus quantitative restrictions on market access and discriminatory conditions may prevail over certain services not subjected to WTO disciplines.<sup>67</sup> On this point, it is interesting to note that one of the most relevant sectors for the Kyoto Protocol is the energy service sector and very few WTO members have made commitments on energy related services.

The Kyoto Protocol specifies that the CDMs purpose is to assist non Annexure I parties in achieving sustainable development, but it does not provide common guidelines for sustainable development criteria. The COP has not yet been able to adopt an international rule for sustainable development criteria relating to CDM projects. It is thus up to the each country to determine their own criteria and assessment process for sustainable development. Annex I parties might therefore discriminate and prefer not to accept CERs originating from non-Annexure I host countries, not fitting their criteria of national sustainable development rules. Should CERs be classified as services, this situation may implicate a violation of the MFN principle and a claim may be directed to the WTO. This example is also applicable should credits be regarded as goods.

Perhaps one of the only precedents for the international trade in government issued environmental permits is the provisions of The US Clean Air Act.<sup>68</sup> Under the US Clean Air Act emissions trading scheme, a power plant is given a cap that is equal to a certain amount of emissions allowances. Should the plant reduced its emissions below its cap, the excess allowances can be sold to other plants which can in return raise its emissions targets to that extent. The Clean Air Act defines that the term “allowance” means “an authorization, allocated to an affected unit by the Administrator under this subchapter, to emit, during or after a specified calendar year, one ton of sulphur dioxide”.<sup>69</sup> Based on

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<sup>67</sup> WTO Secretariate, Trade in Services, Oct. 1999.

<sup>68</sup> Clean Air Act, Subchapter IV-A (1996) *Acid Deposition Control*, 42 U.S.C.A §§ 7651 to 7651o, West. See also J. Werksman, p 168, supra note 55. Available at [http://www.law.cornell.edu/uscode/html/uscode42/html/usc\\_sec\\_42\\_00007651---a000.html](http://www.law.cornell.edu/uscode/html/uscode42/html/usc_sec_42_00007651---a000.html)

<sup>69</sup>Ibid.

this, Weiser concludes that allowances are government issued limited authorizations, thus licences, that allows a holder to emit a specified amount of pollution.<sup>70</sup>

Weiser further argues that The US Environmental Protection Agency (USEPA) is authorized to regulate trade in emission allowances. Parties trading in these allowances must demonstrate to the US Environmental Protection Agency that these allowances represent a reduction below required levels and have to obtain government approval to trade these allowances. The same follows for CERs. Once a project is identified, it is submitted to government for endorsement and then for validation, registration and verification by the CDM Executive Board. Based on certification reports submitted (a written assurance that a project activity achieved the GHG emissions reduction as verified) the Executive Board will issue CERs. Both of these emissions allowances are created by an administrative institution under governmental authority and will not be part of the project or of the services that created the project. Weiser then concludes that emissions allowances are rather a tradable permit that gives the permit holder the right to emit a specified amount of emissions.<sup>71</sup>

Werksman is of the opinion that internationally traded emissions allowances have financial value and could therefore be considered a “negotiable instrument” within the meaning of GATS. Article 5(x) states:

“Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise..... derivative products including, but not limited to, futures and options..... transferable securities.....other negotiable instruments and financial assets...”<sup>72</sup>

Werksman uses the analogy of trade in currency and argues that although currency is not itself a service, good or product, but the sovereign provision of financial service and currency exchange are regulated by the GATS. Translated this implies that, depending on a country’s specific commitments, a country may be required to guarantee market access for units and credits of parties to the Kyoto Protocol. A country would not,

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<sup>70</sup> Supra note 59 , p 296.

<sup>71</sup> Ibid.

<sup>72</sup> Supra note 47, Annex on Financial Services, article 5 (x).

however under GATS rules be required to recognize the allowances, units or credits of another party to the Kyoto Protocol for use within its domestic market.<sup>73</sup> Thus even if GATS applies, which requires that brokers and other financial service providers within a country be free to buy and sell the emissions allowances issued by any other WTO member, a country could none the less, refuse to recognize these allowances as valid for the purpose of offsetting emissions within its territory.

Petsonk also compares emissions trading to sovereign obligations such as currencies or debt, but concludes that neither currency nor debt are created as a consequence of a multilateral treaty obligation and that both arise as a consequence of domestic obligations. Therefore it differs from emissions trading under the Kyoto Protocol.<sup>74</sup>

### 4.3 Subsidies

As described, the Kyoto Protocol envisions emissions trading parties to the Kyoto Protocol, but the final result will probably see countries allocating their rights among their domestic industries, and letting them do much of the international trade themselves. Thus, how will countries make the initial allocation of emission rights and will the initial domestic allocation of allowances be an actionable subsidy and in violation of the Agreement on Subsidies and Countervailing Measures? Will the allocation of allowances *per se* constitute an actionable subsidy? If we regard the distribution of such rights as a financial contribution from government to industry, then that contribution may be considered as a subsidy under the Subsidies Agreement.<sup>75</sup> It could be argued that due to the implementation of obligations committed to under the Kyoto Protocol certain issues will be relative in regard to the allocation of emissions allowances if it can be deemed a subsidy if there is a failure to enforce domestic measures or if payments under the CDM constitute a subsidy? The latter two issues will not be discussed as it falls outside the scope of this research. Article 1 of the Subsidies Agreement defines a subsidy as follows:

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<sup>73</sup> Supra note 55, p. 167.

<sup>74</sup> Supra note 64, p 200.

<sup>75</sup> Supra note 48.



“For the purpose of this Agreement, a subsidy shall be deemed to exist if:

- (a)(1) there is a financial contribution by the government or any public body within the territory of the member in this discussion referred to as “Government” where:
  - (i) a government practice involves direct transfer of funds (eg. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (eg. loan, guarantees).
  - (b) a benefit is thereby conferred”.<sup>76</sup>

Further, Article 1(2), read together with Article 2, the agreement provides only for “specific subsidies” which in general are available only to an enterprise, industry or group of enterprises or group of industries within the jurisdiction of the authority granting the subsidy.<sup>77</sup>

Three categories of subsidies are identified in the Subsidies Agreement.

Article 3 “Prohibited” subsidies: Irrespective of what argument, conditions, or cause a selective discrimination of domestic over imported goods.<sup>78</sup> Prohibited subsidies are subject to dispute settlement by the Dispute Settlement Body.

Article 5 “Actionable” subsidies: Subsidies should have no adverse effects to the interest of other member states, nullification or impairment of benefits accruing directly or indirectly to the other signatories under the general agreement (with special reference to benefits of bound tariff concessions), or serious prejudice to the interests of other members.<sup>79</sup> “Serious prejudice” is formulated as presumed to exist for certain subsidies such as where the total “ad valorem” subsidy of a product exceeds 5 per cent.<sup>80</sup> Members affected by this kind of subsidy, can refer the matter to the Dispute Settlement Body.

Article 8 “Non actionable” subsidies: Subsidies can be non-specific subsidies or specific in nature. It involves assistance in industrial research, pre-competitive development activity, assistance to disadvantaged regions or certain types of assistance to adapt existing facilities to the new environmental requirement imposed by laws or

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<sup>76</sup> Ibid.

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Article 5, Ibid.

<sup>80</sup> Article 6.1 (a), Ibid.

regulations.<sup>81</sup> Should a member be of the opinion that this kind of subsidy is the cause of serious adverse effects to its domestic industry, determination and recommendation may be sought.

A country's decision to restrict the emission of GHGs within its borders, is a country's sovereign right. It is also a country's sovereign right to determine how much each enterprise or economic sector may emit and whether these emission rights are transferable. The Kyoto Protocol does not prescribe how nations are to allocate their assigned amounts. Hence, an Annex I party can allocate AA by means of AAUs, as it wishes. Countries will base their allocation on auctioning,<sup>82</sup> grandfathering,<sup>83</sup> social or economic or political rationales, or earlier action undertaken by industries to reduce emissions.<sup>84</sup>

Irrespective of which approach has been chosen, some groups will have more advantage than others. By definition it will always be so when the government allocates scarce natural resources. The question is if the allocation of allowances constitutes a “financial contribution” or if the transactability thereof is defined as a “financial contribution” in terms of the WTO Agreement on Subsidies.

Each party to the Kyoto Protocol has negotiated legally binding commitments. Thus, the allocation of AA is in effect the distribution of an Annex I party's responsibility to comply with the Kyoto Protocol obligations as an international regulatory regime.

Petsonk argues:

“Identifying Kyoto Protocol allocations as subsidies could be tantamount to saying that any allocation of any responsibility for regulation—whether domestic or international would constitute a subsidy. By that reasoning, any country's sovereign decision to subject some and not all sources of pollution to a regulatory system would constitute a subsidy, and the entire

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<sup>81</sup> Supra note 64, p. 204.

<sup>82</sup> Any amount of the allocated allowances may be auctioned during the period of 2008-2012.

<sup>83</sup> Allocation based on historic emissions levels.

<sup>84</sup> This type of approach (with many variants) a nation or a group makes a commitment and agrees on the formula for allocation, based on the history of the emissions performance prior to the commitment period allocation. Supra note 63, p. 206 and 207.

national and international framework of environmental regulation would be subject to subsidies challenge”.<sup>85</sup>

Therefore regarding the allocation of allowances as a subsidy will not resort under the Subsidies Agreement of the WTO. It will thus not be regarded as a prohibited or actionable or even a non actionable subsidy.

#### 4.4 Conclusion and Recommendations

It will be costly for parties to the Kyoto Protocol to comply with their obligations under the Kyoto Protocol in order to reduce greenhouse gas emissions. According to economic analysis the most cost efficient way to reduce GHGs emissions is to apply free trade principles as this also presents the best option to reduce GHGs on global scale. Therefore, the need for a framework which incorporates the principles of non discrimination and transparency exists. It would be favorable to incorporate emissions trading into the WTO body of rules coupled with the fact that the WTO is being pressured to address environmental issues. Within the body of rules of the WTO there is currently no framework for the classification of emissions allowances created by the Kyoto Protocol to rely on or give guidance.

It seems that there is consensus among most academic scholars that emission allowances will not be characterized as goods or products. Government to government trading of assigned amounts does not create a market in goods, rather it corresponds to a sovereign to sovereign exchange of commitments. The sovereign exchange of assigned amounts could be viewed as the reallocation of the overall assigned amounts established by the Kyoto Protocol rather than the creation of a market. Goods or products are traditionally also seen as being more tangible. In this case, there is no interaction with WTO rules. Petsonk continues to argue, that should the Gold Coin case be invoked, it opens the possibility that emissions allowances might be defined as investment goods.

As for GATS, Werksman argues that emissions allowances might be defined as “negotiable instruments” and compares it to currency but Petsonk argues that emissions

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<sup>85</sup> Supra note 64, p. 207.

allowances are not analogues to currency or debt. Lastly, Weiser argues that emission allowances are tradable permits or licenses. The application of GATS is not ruled out. GATS might be applicable in that the parties can identify which sector, sub sectors or activities they will list in their schedules of commitments, these schedules can be modified, but only under certain circumstances and provisions. There are currently no services listed that are analogues to the issuance of ERUs or CERs or place emission allowances under the ambit of GATS. GATS allow for WTO members to reclassify definitions of specific services from time to time. The possibility thus exists that these lists can include services analogous to the issuance of Kyoto Protocol units or credits in the future.<sup>86</sup> Further, many of the GATS disciplines are also in a formative stage and have yet to be tested in a dispute.

Should allowances be characterized as goods or services, it may prima facie be seen as a violation of WTO law concerning the non discrimination principle encapsulated in the MFN and NT principle. For example:

The MFN principle can be implicated if a non-Annex I country choose to accept a CDM project by an Annex I country, based on the project sponsors country of origin or give preferential treatment to that country's service providers;

Breach of NT principle can be claimed if a non-Annex I country adopt different project rules and standards for domestic and non-domestic project developers or where a non-Annex I country give preferential treatment to its domestic service providers.

Measures like these would thus be seen as arbitrary or unjustifiable discrimination between countries where like conditions prevail.

The WTO rules allows further for exceptions to these principles as provide for in GATT article XX or GATS article XIV's general exceptions provisions. There exists the possibility that provisions of the Kyoto Protocol might be covered by these exceptions lessening potential conflict between the two regimes. These provisions allow countries to adopt or enforce trade measures that are "necessary to protect human, animal or plant life

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<sup>86</sup> See [http://docs.google.com/Doc?id=w.dc4wk75\\_g6bggd](http://docs.google.com/Doc?id=w.dc4wk75_g6bggd)

or health”,<sup>87</sup> or that relate “to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption”.<sup>88</sup> However, this calls for a discussion on its own merits.

Initial allocation of emissions allowances will probably not be seen as a specific subsidy and therefore not qualify as actionable and subject to countervailing measures of other WTO members. The allocation of emissions allowances can neither be regarded as financial contributions nor as an income or price support. Allocation of allowances to private entities does not confer a benefit according to article I of the Subsidies Agreement because it is accompanied by an obligation to reduce GHGs to a certain level.

For the short term a license principle approach should be implemented until a framework has been created in the WTO for the classification of emission allowances and the trading there of. Referring to the US Clean Air Act, both CERs and SO<sub>2</sub>'s are a government granted permission as discussed. Thus by clearly defining CERs (as well as “emissions reduction units” under Article 6, joint implementation and “assigned amount units” under Article 17, emissions trading) as a form of license or permit, Kyoto Protocol Parties could lessen the possibility of potential conflict with WTO rules or an attempt to use the WTO dispute settlement understanding to preempt or to redefine COP intentions. Parties might include language in the CDM implementing decision that paraphrases the U.S. Clean Air Act language: “CERs shall constitute a limited authorization to emit carbon dioxide equivalent in accordance with the rules in and under the Protocol”.<sup>89</sup> Also, to view CERs as licenses the COP/MOP would have no sole authority to decide the following: whether CER trade with non Parties would be restricted, whether CDM eligibility criteria could curtail a Party's ability to use CERs or whether the COP or a designated authority might respond to a case of non-compliance by suspending the right of a Party to export, import or redeem CERs. In addition, the license view could protect the right of individual parties to enact domestic regulations that restrict the use of CERs in ways not specifically

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<sup>87</sup> GATT Article XX (b), supra note 42 and GATS Article XIV (b), supra note 43.

<sup>88</sup> GATT Article XX (g), supra note 42.

<sup>89</sup> Supra note.

articulated under the international rules. This might eliminate the uncertainty for policy makers as to whether their decisions could run foul with the WTO.<sup>90</sup>

The dialogue between the US and the EC illustrates existing and potential disagreements between the WTO and the Kyoto Protocol, and it shows the need for the WTO to effectively apply itself to conflicts that relate to trade and the environment.

To date, however, neither the UNFCCC nor the Kyoto Protocol has set up committees to examine possible conflicts with the WTO. They anticipate studying the issues of substantive and institutional compatibility only once the first round of the Kyoto Protocol projects is sufficiently in progress. Because climate change institutions have not immediately addressed the issue and that there is currently an absence of a suitable centralized environmental dispute settlement forum coupled by the fact that it might be favourable to incorporate emissions trading into the WTO body of rules, are all arguments that the WTO, by default, has become the most probable forum to define how questions are framed and in the long term, how they are resolved.<sup>91</sup>

Thus, for a WTO member country that is also a party to the Kyoto Protocol, the biggest challenge is to pursue both the Uruguay Round and the Kyoto Protocol objectives in the short term and in the long term. Policy makers can do this by enhancing the synergy among policies and by avoiding any conflict that might arise from unilateral discriminatory trade measures.

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<sup>90</sup> Supra note 59, p 296.

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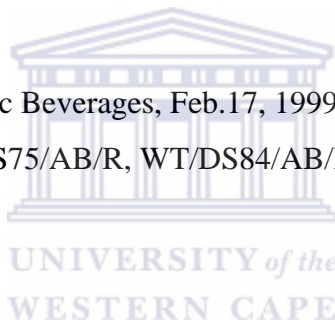
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