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Unilateral Carbon Border Measures: Key Legal Issues

Anuradha R.V.

Abstract

Parties to the United Nations Framework Convention on Climate Change (UNFCCC) have been engaged in discussions on the future of the climate change regime. While the principle of "common but differentiated responsibilities" has so far played a central role in defining rights and responsibilities of countries, there has been increasing demand from the developed countries that both developed and developing countries would need to undertake commitments to address the problem.

Pending the conclusion of a legally binding international agreement to address commitments post-2012 (when the current commitment period under the Kyoto Protocol to the UNFCCC ends), discussions in the EU and the US indicate the possibility that provisions relating to unilateral trade measures may be considered on imports from countries that do not have comparable greenhouse gas reduction norms. It is important to bear in view that the UNFCCC itself envisages the possibility of unilateral measures, though it is silent on the actual triggers that would justify implementing such measures.

Any unilateral trade action would have serious implications for the balance of rights and obligations that a multilateral agreement on climate change may hope to achieve. This could however be avoided if countries are able to achieve clarity on the conditions that need to be met prior to the exercise of any unilateral trade measures under the UNFCCC framework. This paper deals with the issue of the possible ways in which this issue may be addressed.

***Jel classification**: K32, K33, Q56, Q58*

***Keywords**: Climate change; UNFCCC; Unilateral Trade Measures; Trade and Environment.*

Executive Summary

The principle of "common but differentiated responsibilities", popularly referred to as the CBDR principle, lies at the heart of the United Nations Framework Convention on Climate Change (UNFCCC) of 1992. Flowing from this principle, and as further elaborated in the Kyoto Protocol of 1997, mandatory requirements relating to quantified reduction commitments in respect of greenhouse gases (GHGs) were applicable only for developed countries. With the first commitment period under the Kyoto Protocol ending in 2012, there has been increasing clamour from the developed world that that they could not continue to shoulder the burden of mandatory obligations on their own, and that developing countries, which are major emitters of greenhouse gases, would need to undertake some commitments. The Copenhagen Accord of December 2009 and the Cancun Agreements of December 2010 reflect the emergence of some of these ideas.

Pending the conclusion of a legally binding international agreement to address commitments post-2012, policy level discussions in the EU and the US indicate the possibility that provisions relating to unilateral trade measures may be imposed on imports from countries that do not have comparable GHG reduction norms.

Any unilateral action would have serious implications for the balance of rights and obligations that a multilateral agreement may hope to achieve under UNFCCC. It is important to bear in view that the UNFCCC itself envisages the possibility of unilateral measures under Article 3.5, though it is silent on the actual triggers that would justify implementing such measures. The spectre of unilateral action under Article 3.5 is likely in two possible scenarios: (i) the failure of countries to arrive at a successor to the Kyoto protocol or (ii) the conclusion of an agreement that countries feel does not meet with their negotiating objectives.

The negotiating texts for the Conference of Parties (COPs) held at Copenhagen and Cancun consisted of discussions on options on the issue of unilateral measures, especially trade measures, under Article 3.5. The issue, however, remains highly contentious and unresolved. It is expected to form a part of the discussions for the COP at South Africa in December 2011. How this is addressed will be of tremendous importance especially in view of the evolving set of obligations for developing countries.

Since there is no clear framework of agreed principles for unilateral action, any exercise of unilateral trade measures is likely to result in trade disputes under the WTO. The design and actual implementation of unilateral trade measures will, to a large extent, determine their WTO consistency. Nevertheless, a preliminary examination of the basic principles against which such measures are likely to be tested reveals that such a dispute will throw up a range of new conceptual issues and challenges for the WTO dispute settlement mechanism, and existing jurisprudence is not definitive on how these issues would be ultimately evaluated. Raising a dispute at the WTO

therefore, may not provide all the answers to the issue of unilateral carbon border measures.

To achieve clarity, it would be important to consider the conditions that need to be met prior to the exercise of any unilateral trade measures within the context of the climate change negotiations. One can argue that, if under the ongoing negotiations, a satisfactory agreement on reduction commitments is reached for the period post-2012, a strong case could be considered for modifying Article 3.5 of the UNFCCC to clarify that no party to a binding protocol under the UNFCCC can take unilateral trade measures related to climate change against another party to such a protocol. However, it must be acknowledged that given present positions at the UNFCCC negotiations, the chances of securing an outright ban on unilateral measures are not very high.

In view of this, what can be done realistically is to minimise the need and opportunity for use of unilateral trade measures. For this too, the first imperative would be to have a satisfactory agreement on reduction commitments for future periods as envisaged under the Kyoto Protocol. Trade measures within the framework of a binding agreement/protocol, should be confined only to purposes of enforcement and compliance, for which multilateral procedures would need to be developed. Such procedures could envisage trade measures as a last resort to enforce compliance, but only on the basis of multilateral scrutiny and approval through a mechanism, which would include the following features:

- The procedures should provide for multilateral determination of non-compliance followed by multilateral authorisation of measures to obtain compliance, according to the precedent set by the Montreal Protocol and the Convention on International Trade in Endangered Species (CITES).
- The multilateral procedures should provide for transparency, reporting, surveillance, consultation, arbitration and dispute settlement and should be elaborately designed to ensure that members implement their obligations.
- Trade measures should be the last resort for multilateral authorisation after all other steps have failed to obtain compliance.
- Trade measures to obtain compliance should be envisaged only against non-compliance with substantive obligations on reduction targets and should not be authorised for procedural shortcomings.
- Should the elements for International Consultation and Analysis (ICA) and criteria for measurement, reporting and verification (MRV) of nationally appropriate mitigation actions, as envisaged under the Cancun Agreements, be converted into elements of a legally binding agreement, the remedy for non-compliance should not be trade measures.

While it may not be possible to eliminate the possibility of unilateral action, a strong multilateral framework is more likely to confine the limits of any action to an agreed set of principles.

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Introduction

In the climate change debate, there is almost universal agreement on the basic points that (i) climate change is a global issue which has local impact, (ii) unilateral or local efforts are not sufficient to address the issue of such magnitude and (iii) multilateral efforts lie at the heart of any real solution to the global problem. When the United Nations Framework Convention on Climate Change (UNFCCC) was concluded in 1992, it recognised that (i) the largest share of historical and current global emissions of greenhouse gases has originated in developed countries (ii) per capita emissions in developing countries are still relatively low and (iii) the share of global emissions originating in developing countries will grow to meet their social and development needs. Keeping these aspects in view, it attempted to achieve a balance through the principle of "common but differentiated responsibilities" (referred to as the "CBDR principle") and predicated actions by countries on considerations relating to equity and the respective capabilities of countries.

Flowing from the CBDR principle, and as further elaborated in the Kyoto Protocol of 1997, mandatory emission reduction commitments were applicable only to developed countries. The US and Australia did not ratify the Kyoto Protocol at that time since they could not agree to the mandatory reduction commitments. Australia ratified it a decade later in 2007 but the US has not. With the first commitment period under the Kyoto Protocol ending in 2012, there has been a flurry of activity in the past few years on the next steps. A critical aspect of recent discussions has been the increasing clamour from the developed world that that they could not continue to shoulder the burden of mandatory obligations on their own, and that developing countries, which are major emitters of greenhouse gases, would need to undertake some commitments. The Copenhagen Accord of December 2009 reflects these ideas, and the Cancun Agreements of December 2010 further build on these.

Neither the Copenhagen Accord nor the Cancun Agreements have the status of a legally binding treaty. The Copenhagen Accord is worded as something that the Conference of Parties (COP) 'take note of', and is widely hailed as a political agreement between some parties but not all. The Cancun Agreements were adopted as

[1] The author is Partner, Clarus Law Associates, New Delhi, and an External Consultant to ICRIER. She thanks Mr. Anwarul Hoda for his invaluable comments and guidance. The author also expresses her sincere thanks to Ms. Debra Steger and Ms. Kasturi Das for their comments, which were very helpful in refining the contents and focus of the paper. The author would like to gratefully acknowledge the comments and interventions by Ambassador C. Dasgupta, Mr. Atul Kaushik and Mr. Shravan Nigam at the seminar organised by ICRIER in February 2011 where an earlier version of this paper was presented. Thanks are also due to Ms. Sumiti Yadava for her research assistance. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of ICRIER. Any errors or oversights are attributable only to the author.

decisions by the COP, although there were strong objections from Bolivia. COP decisions, however, do not have a legally binding character, unlike a new protocol or an amendment to the Kyoto Protocol. The COP decisions at Cancun, in fact, also state that "nothing in this decision shall prejudge prospects for, or the content of, a legally-binding outcome in the future". The Cancun Agreements, nevertheless, reflect the commitment of parties to work on the principles contained therein. The main significance of the Cancun Agreements for the purpose of the present discussion lies in its provisions, which reflect a move towards more concrete obligations for developing countries than was present under the Kyoto Protocol.

Another significant development has been that legislative efforts in the US and the EU to cap greenhouse gas emissions also contain provisions that provide the ability to impose unilateral trade measures on imports from countries that do not have comparable GHG reduction norms. The debate on this aspect is still at a conceptual stage: while the US House of Representatives agreed by a narrow margin on the American Clean Energy and Security Act (ACESA), it has not been passed at the US Senate, whose approval is necessary to implement the law. Uncertainty continues to prevail over US climate policy, and it is not entirely clear whether the US will pursue with ACESA's provisions for border measures against imports. In the EU, the Revised Directive of 2009 of the European Union Emission Trading System (EU-ETS) contains provisions that provide EU legislators the option to consider making the EU-ETS applicable to importers (i.e., importers would have to comply with the same norms as EU manufacturers relating to emission allowances).[2] Such an option is to be exercised under the EU-ETS in the event there is no international agreement on carbon emissions.

The key concerns driving the measures in both the US and the EU are two-fold: first, the need to address "carbon leakage" and, related to that, the need to address domestic industry's competitiveness concerns. "Carbon leakage" refers to two broad types of situations: (i) the potential shift of emissions-intensive manufacturing from a country that enacts emissions reduction legislation to foreign jurisdictions with no or less onerous emissions restrictions and (ii) the offsetting of stringent norms in one country by the enhanced emissions in the country where the manufacturing activity shifts. "Competitiveness" concerns refer to the impact on competitiveness of domestic industries, which may occur due to loss of market share to competitors located in countries with less stringent laws, as well higher compliance costs of stringent climate legislation.

Countries like India, China and several other developing countries, have expressed strong concern and have opposed any form of unilateral trade measures relating to climate change, arguing that such measures would have serious implications for the balance of rights and obligations that a multilateral agreement may hope to achieve.

[2] Directive 2009/29/EC of 23 April, 2009

It is important to note that the current framework of the United Nations Framework Convention on Climate Change (UNFCCC) envisages the possibility of unilateral trade measures under Article 3.5. Article 3.5 is, however, silent on the actual circumstances that might justify such measures. In practical terms, unilateral action under Article 3.5 is likely under two situations – one, if countries fail to arrive at reduction commitments for the period beyond 2012 pursuant to the emissions reduction regime agreed to in the Kyoto protocol and two, if countries feel that any agreement concluded does not meet their negotiating objectives.

The absence of a satisfactory agreement would certainly create a fertile ground for unilateral trade actions. With a satisfactory agreement, the risk of unilateral action related to climate change by any government should, in principle, disappear but there could still be concerns on compliance issues that could lead to such action. This would point to the need for laying down clear procedures for compliance with and enforcement of the provisions of the agreement.

Any use of unilateral trade measures is likely to result in a trade dispute under the WTO. Most commentators on this subject acknowledge, almost universally, that any unilateral action involving carbon border adjustment of imports would be challenged under the rules of the World Trade Organization (WTO).[3] The past two years have seen the emergence of a distinct body of literature and analysis on the economics and legalities of carbon border measures. Most of the writings so far have based their analysis on the emerging legislative proposals in the US. They acknowledge the impetus from domestic industry to seek trade action against countries that set lower or no price on carbon inputs ('competitiveness concerns'). With regard to carbon leakage concerns, a few of the writings have concluded that unilateral emission cuts by industrialised countries will have minimum carbon leakage effects in the first place, but the pressure for trade action is likely to emerge from energy-intensive manufacturers whose exports, as well as market shares, are likely to decrease.[4]

The trade and climate change linkage has been a significant item in the negotiating texts discussed at the Conference of Parties held at Copenhagen in December 2009 and Cancun December 2010. However, the Copenhagen Accord has not incorporated any text on this issue and one of the Cancun Decisions (1.CP 16) merely repeats the language of Article 3.5 of the UNFCCC. In fact, the highly contentious nature of discussions at Cancun led to the deletion of any references to the issue of trade measures from the decision that emerged out of the COP. This issue is expected to be considered at the next Conference of Parties at Durban, South Africa, in December 2011.

[3] *See, for example,* Hufbauer et al (2009), Werksman (2009), Marceau (2009); Dhar and Das (2009)

[4] Mattoo et.al (2009). They analyse other writings on this issue including a study by Carolyn Fisher and Alan Fox which concludes that while all potential policy measures are likely to support domestic production and help avoid some of the losses in production associated with carbon tax, none is necessarily effective at reducing global emissions (Fisher and Fox, 2009)

Unilateral action related to climate change may be more difficult to check and contain without an agreement on reduction commitments for subsequent commitment periods beyond 2008-12, as envisaged in the Kyoto Protocol, and agreed procedure for compliance and enforcement. As mentioned earlier, most writings on this subject so far have also concluded that if such measures are put in place, they would result in disputes under the WTO.[5] While relevant principles from the jurisprudence under WTO provide insights into how such trade measures are likely to be addressed, it is not possible to conclude with certainty the outcome in a particular case. That would depend on several variables, such as whether there is any legal text that emerges out of the ongoing negotiations under the UNFCCC, clarifying the circumstances of unilateral trade measures for climate change concerns and the actual design as well as application of such measures.

This paper seeks to contextualise the discussions based on current available information on the approach of unilateral trade measures under US and EU's legislations, current WTO jurisprudence on the subject, and the policy imperatives that will need to be considered by negotiators at UNFCCC negotiations while addressing the issue of unilateral trade measures for addressing climate change concerns.

Outline of the Paper

The outline of this paper is as follows: Part I will seek to provide an overview of the legislations in the US and EU. Part II will discuss the framework of rights and obligations under the current legal framework of the UNFCCC and the WTO and their approach towards unilateral trade measures. Part III will highlight some of the recent textual formulations under the UNFCCC discussions to address trade and climate change. In view of the above discussions, Part IV will focus on the essential policy options that would need to be considered.

I Trade Measures in Climate Legislation

IA Climate Change Legislation in the United States

As stated earlier, the US House of Representatives on June 26, 2009, passed the American Clean Energy and Security Act (ACESA). The Act's stated aim is to deploy clean energy resources, increase energy efficiency, cut global warming and pollution, and transition to a clean energy economy. The ACESA would need to be passed by the US Senate before it can be implemented. At the Senate, the "Clean Energy Jobs and American Power Act", also known as Kerry-Boxer Bill ("KB Bill"), was introduced in September, 2009. In May 2010, this version was replaced by the "American Power Act", also called the Kerry-Lieberman Bill. Debates and discussions continued until June 2010 with no concrete outcome. As stated in the introduction, uncertainty

[5] See, supra n.2.

continues to prevail over US climate policy and it is not entirely clear whether or not the US will proceed with ACESA's provisions for border measures against imports.

Nevertheless, for the purposes of our discussion, it would be useful to examine briefly the key elements on border measures of the ACESA, as well as the KB Bill. Title IV of ACESA as well as sections 775-78 of the Kerry-Lieberman Bill, deals with the International Reserve Allowance Program. The requirement under these provisions are for importers to buy carbon allowances when bringing in commodities in energy intensive and trade-exposed sectors, (such as steel, aluminium, or cement) from countries that fail to adopt carbon control programmes similar to that in the US. The border adjustment would take effect in 2020 under the Kerry-Lieberman Bill to the extent that carbon-related competitive gaps remain with other countries and are not covered by the allowance rebates.

The main concern for developing countries is likely to be that both the ACESA and the KB Bill indicate that merely being a party to an international agreement, (such as the UNFCCC or the Kyoto Protocol) may not be enough, if such multilateral agreements do not adhere to the imperatives listed under the relevant US law. Other important concerns with regard to the provisions of the ACESA and the KB Bill are as follows:

- The U.S. Government expresses its commitment to international negotiations and to the conclusion of a multilateral agreement that commits "*all* ***major greenhouse gas-emitting nations*** *to contribute* ***equitably*** *to the reduction of global greenhouse gas emissions."*(Emphasis added). The basis on which such countries would be identified is not provided in the ACESA or the Kerry Lieberman Bill. However, the US has been very clear in its political statements that such countries would necessarily include India and China. At present, India has emphasised that it is not in a position to undertake emission reduction obligations. This is reaffirmed by several studies, including a recent one by the World Bank, which finds that India cannot afford to undertake deep emission cuts without sacrificing poverty alleviation plans and development needs.[6]
- Section 777(c) of the Kerry Lieberman Bill states that 'exemptions' from the international allowance programme would apply to countries <u>*only*</u> if an international agreement, to which both a third country and US are a party, requires that the country undertakes "*at least as stringent"* obligations as that required under US legislation. This clearly indicates that such agreement would have to ensure that the required GHG reduction by countries is *as stringent as* US's domestic law. The US approach, therefore, seems to indicate that there would be no room for differential responsibilities between countries under an international agreement. The Bill's

[6] World Bank (2009). The same study also finds that current and future emission trends for India are aimed at basic energy services, which are necessary for its development goals.

exemptions are only in respect of countries that have GHG intensity[7] that is equal to or less than the US. This also reflects that there may be no room for *differential responsibility* under any international regime and that the only acceptable regime is GHG intensity that is "equal to or less than the US."

- Both ACESA and the KB Bill had provisions that set forth targets for emission reductions within the US, and established a number of mechanisms to address the cost impact on consumers and businesses and to support clean energy technologies. It also established refundable tax credits and various funds to address the economic burden for domestic businesses and allowed for unlimited borrowing from future allowances, and banking of future allowances without any restrictions or penalties. For importers into the US, however, there were no provisions relating to allocation of free allowances, banking of allowances or borrowing from future allowances.

IB Climate Change legislation in Europe: The "Climate Action and Renewable Energy Package"

The climate and energy package adopted by the EU in April 2009 comprises four legislative texts.[8] The issue of carbon border measures is addressed in one of these legislative texts, the Directive 2009/29/EC of April 23, 2009, which amends Directive 2003/87/EC (also referred to as the "Revised EU-ETS Directive"). This directive revises the EU Emissions Trading System ("EU-ETS") by introducing new sections in the previous Directive 2003/87/EC.

The Revised EU-ETS Directive is premised on the commitment to reduce the overall greenhouse gas emissions by 20 per cent below 1990 levels by 2020, and by 30 per cent, *if* an international agreement is concluded under the UNFCCC committing "***other developed countries to comparable emission reductions*** and ***economically more advanced developing countries to contributing adequately according to their responsibilities and respective capabilities***".[9]

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[7] 'GHG intensity' is an indicator that measures quantity of emissions per unit of economic output. GHG emissions are measured in tons of carbon dioxide (CO2), or in CO2 "equivalent" tons, in case of other GHGs such as methane (CH4) or nitrous oxide (N2O).

[8] The climate and energy package consists of the following legislative texts: (1) A directive revising the EU Emissions Trading System ("EU ETS"), which covers some 40 per cent of EU greenhouse gas emissions (discussed in para 3.2) (2) an "effort-sharing" decision setting binding national targets for emissions from sectors not covered by the EU ETS (3) a directive setting binding national targets for increasing the share of renewable energy sources in the energy mix and (4) a directive creating a legal framework for the safe and environmentally sound use of carbon capture and storage technologies. The package is complemented by two more legislative acts that were agreed to at the same time. The first is a regulation requiring a reduction in CO_2 emissions from new cars to an average of 120g per km, to be phased in between 2012 and 2015, and further to 95g per km in 2020. This measure alone will contribute more than one-third of the emission reductions required in the non-ETS sectors. The second involves a revision of the fuel quality directive requiring fuel suppliers to reduce greenhouse gas emissions from the fuel production chain by 6 per cent by 2020.

[9] Para 3, Revised EU ETS Directive.

Recognising the Possibility of "Carbon Leakage"

Para 24 of the Revised EU-ETS Directive envisages 'carbon leakage' as a possibility ***in the event other developed countries or major emitters of greenhouse gases fail to participate in an international agreement to curb emissions***. It states that such failure could result in increased GHG emissions in third countries where industry is not subject to ***comparable*** carbon restraints and put certain energy-intensive sectors of the EU which compete internationally, at an economic disadvantage.[10]

Based on this assessment, the Directive provides for two options with a view to putting installations from the Community that are at significant risk of carbon leakage and those from third countries ***on a comparable footing.*** These are (a) to raise the amount of free allocation of emissions to energy-intensive industries that are determined to be exposed to a significant risk of carbon leakage or (b) introducing an ***effective carbon equalisation system.***

The nature and contours of the carbon equalisation system are yet to evolve. As of now, the EU Directive outlines certain principles. These are

(i) requirements on importers from third countries should be no less favourable than those applicable to installations within the Community
(ii) any action taken would need to be in conformity with the principles of the UNFCCC, in particular, the principle of common but differentiated responsibilities and respective capabilities, taking into account the particular situation of least developed countries (LDCs) and
(iii) the requirement for conformity with EU's international obligations, including obligations under the WTO agreements.

Main Concerns with the EU-ETS

From the perspective of developing countries, the primary concerns with the 'carbon equalisation' proposal in the EU-ETS are as follows:

- ***Obligations on developing countries***: The EU-ETS places the primary onus for emission reductions on developed countries, whose obligations need to be 'comparable' under the EU Directive. But the Directive also states that developing countries which are *economically more advanced* are required to take some form of action under international negotiations and contribute *adequately* according to their responsibilities and respective capabilities. What the EU would consider as *economically more advanced* and how it would assess adequacy of commitments, however, is not clear.

[10] Para 24, Revised EU-ETS Directive.

- ***Carbon leakage***: The directive specifies that 'carbon leakage' could result if other developed countries *or major emitters of greenhouse gases* fail to participate in an international agreement to curb emissions. The criteria to determine *major emitters of greenhouse gases*, as in the case of *economically more advanced developing countries* referred to in the preceding paragraph, are not specified. It is possible, for example, that a developing country like India may be considered under both these categories.

More importantly, the text of the directive in relation to 'carbon leakage' refers to carbon leakage resulting in industry in third countries not subject to 'comparable' carbon restraint. In other words, any responses to carbon leakage are likely to be based on *comparability* of controls over industry, as compared to the EU, both in other developed countries and developing countries that qualify as 'major emitters'. This obligation is different from the previous paragraph wherein comparability of action was envisaged only for 'other developed countries'. By expanding comparability of action for 'major emitters', the directive potentially widens its coverage from only developed countries to include developing countries that are major emitters as well.

II Unilateral Trade Measures under the UNFCCC & the WTO

IIA Unilateral Measures and the UNFCCC

As explained in the introduction to this paper, the UNFCCC recognises the possibility of unilateral trade measures under Article 3.5. The text of Article 3.5 reads as follows:

> "The Parties should cooperate to promote a supportive and open international economic system that would lead to sustainable economic growth and development in all Parties, particularly developing country Parties, thus enabling them better to address the problems of climate change. Measures taken to combat climate change, including unilateral ones, *should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade".* (Emphasis added).

The UNFCCC clearly envisages the possibility that measures to combat climate change could include 'unilateral measures'. The two safeguards against its use are worded in broad terms, i.e., such measures should not *(a) constitute a means of arbitrary or unjustifiable discrimination or (b) a disguised restriction on international trade.* Interestingly, these phrases reflect the language used in Article XX of the World Trade Organization's General Agreement on Tariffs and Trade (GATT). The GATT's primary concern is with commitments on tariff levels and reduction by WTO members. Its cornerstone principles include the principles of 'national treatment' and 'most-favoured nation treatment', both of which will be discussed in Part II.B below. Article XX deals with the general exceptions to GATT obligations on several grounds,

including environmental concerns. There have been several WTO cases that have dealt with Article XX exceptions, and lay down a fairly complex set of principles for exercise of unilateral action in deviation of GATT commitments.

The text of the UNFCCC, however, is silent as regards the circumstances in which unilateral measures can be envisaged. Article 3.5 seems to envisage unilateral measures as part of a broader range of policy measures that a country may be undertaking on its own with a view to addressing climate change. Any interpretation of Article 3.5 would need to take into account the context in which it is present, i.e., the overall framework of rights and responsibilities under the UNFCCC. This flows from a basic rule of treaty interpretation that a treaty provision must be interpreted in good faith in accordance with its ordinary meaning and in light of its object and purpose.[11] The context in which Article 3.5 is present includes the following principles, among others:

- While parties to the UNFCCC are required to address climate change issues in a co-operative manner, the primary responsibility for tackling climate change is on developed countries. The principle of common but differentiated responsibilities and respective capabilities of countries is emphasised as a fundamental basis for obligations of countries.[12]
- Developed country parties are required to take all practicable steps to promote, facilitate and finance, as appropriate, the transfer of, or access to, environmentally sound technologies and knowhow to other parties, particularly developing country parties, to enable them to implement the provisions of the convention.[13]
- There is a clear linkage between adherence by developing countries of their obligations under the convention, to the 'effective implementation' by developed countries of their commitments to provide financial resources and transfer of technology. Developing country parties' obligation to implement effectively their commitments under the convention is said to depend on the effective implementation by developed country parties of their commitments related to financial resources and transfer of technology.[14]
- There is recognition that economic and social development and poverty eradication are the first and overriding priorities of the developing country parties.[15]
- Apart from the provisions above that provide emphasis on differential treatment of developing countries, the UNFCCC also places special emphasis on addressing the needs of certain categories of developing countries such as small island countries, least developed countries, and those prone to environmental disadvantages such as low lying coastal areas, semi-arid and arid zones, countries prone to natural disasters, land-locked and transit countries, etc.[16]

[11] Article 31(1) of the Vienna Convention on the Law of Treaties.
[12] Article 3.1 and Article 3.3, UNFCCC
[13] Article 4.5, UNFCCC
[14] Article 4.7, UNFCCC
[15] Id.
[16] Article 4.8, 2.9 and 4.10, UNFCCC

- The mandatory obligations on emission reductions under the Kyoto Protocol are only with respect to Annex 1 countries, which consists of only developed countries

The actual implementation of these principles are also informed and influenced by the Kyoto Protocol, Decisions of the Conference of Parties to the UNFCCC; any subsequent agreements between the parties will also inform the implementation and interpretation of these principles.

The Cancun Agreements

As discussed in the introduction to this paper, the Copenhagen Accord of December 2009 is widely perceived as a political agreement between some parties to the UNFCCC. The Cancun Agreements of December 2010 was adopted as COP decisions and enunciate principles that could mark the beginning of a shift in the overall balance of rights and obligations under the UNFCCC. While the Cancun Agreements do not create legally binding and enforceable obligations on developing countries yet, these are significant developments for the trends they portray in the evolution of future rights and obligations under the international negotiating process. To understand this better, it would be useful to outline the principal elements of the Cancun agreements for developing countries. While the Cancun texts emphasise the CBDR principle, and developing countries such as India are not yet required to assume any binding emission reduction obligations, the decisions reflect the principle that developing countries are required to undertake and report certain measures that are geared towards emission reductions. In contrast to this, the Cancun Agreements do not spell out any binding emission reduction targets, and only "*urges* developed country parties to increase the ambition of their economy-wide emission reduction targets". The discussion on the second commitment period between parties to the Kyoto Protocol is also ongoing at the UNFCCC; but nothing concrete has emerged out of these discussions yet.

The Cancun Agreements specify that developing countries need to undertake "*nationally appropriate mitigation actions*" ('***NAMA***') aimed at achieving "deviation in emissions relative to business as usual emissions in 2020". As explained above, there is no binding emission reduction commitment on India or any other developing country. The obligation to undertake "NAMA" essentially means that a developing country needs to adopt and report its commitment to policies and the actions that it plans to undertake in order to ensure some reduction in greenhouse gas emissions. In essence, a 'NAMA' commitment does not require India to commit to any specific emission reduction targets. However, India would be required to ensure that it undertakes and reports its actions aimed at reducing some greenhouse gas emissions, subject to an overall qualification that this should represent "deviation from business as usual emissions in 2020". Through a series of provisions, which are discussed below, the Cancun Agreements seek to subject such reported actions to scrutiny by the COP.

It is important to note that there is no agreed or common understanding yet of what 'NAMA' means. India had earlier argued that 'NAMA' means *voluntary reductions* by developing countries that *require to be supported and enabled* by technology transfer from developed countries. The Cancun Agreements, following from the Copenhagen Accord, emphasise that some NAMA would be supported by external funding while a developing country would be required to undertake others on its own and that each set of actions would be subject to some degree of external scrutiny. The Cancun Agreements also recognise differences in understanding 'NAMA' and call for workshops to understand the diversity of mitigation actions submitted, the underlying assumptions and the support needed to implement these actions.

The specific obligations that would fall upon a developing country like India under the Cancun Agreements can be summarised as follows:

(i) Voluntarily provide information on 'NAMA' which are required to be "measured, reported and verified" ('**MRV**') at the national level, for which guidelines are to be developed under the UNFCCC.
(ii) Identify the 'NAMA' for which it would require international support and costs for the same. All internationally supported action will be subject to "international MRV", guidelines in respect of which also are to be developed.
(iii) Ensure periodic national communications based on the format to be notified. The Agreements specify that there will be "international consultation and analysis" ('**ICA**') of reports made to the technical body of the UNFCCC, which would involve "analysis by technical experts in consultation with the Party concerned", and "result in a summary report."

Scrutiny and assessment of mitigation action that have availed of international funding is a perfectly understandable requirement. The concern with the Cancun Agreements, however, is with regard to the overarching requirement for assessment of all domestic actions. Until the standards and parameters for MRV and ICA are put into place, this is likely to remain an issue of concern. Debates on this issue often refer to MRV and ICA as requirements relating only to procedural requirements and transparency. The guidelines for implementing these, the identification and role of 'technical experts' as required for ICA, and the legal impact of the outcome of such reporting and assessment, would all be crucial for assessing whether MRV and ICA are meant to result in non-binding recommendations or in binding findings, compliance with which is mandatory.

IIB WTO and Trade Measures for Environmental reasons

If any unilateral action is a trade measure, as currently envisaged under the US and EU frameworks outlined above, the affected party would likely consider either one or both of the following approaches: (i) to explore avenues for resolving the issue within the framework of the UNFCCC; or (ii) to explore the possible remedies within the WTO

framework. Within the UNFCCC framework, as with the WTO, the first option is to resolve differences through consultations. Should consultations fail, a country would have the option of submitting a dispute to the International Court of Justice or to arbitration.

Any unilateral trade measure to address climate change concerns is likely to involve the WTO as well, and a WTO dispute is likely to be raised to address issues relating to the compatibility of such a measure with the provisions of the WTO. In the event of such a dispute, principles of the UNFCCC are also likely to be examined. As the WTO's Appellate Body has observed on previous occasions, the WTO does not exist in 'clinical isolation', and would need to be informed by principles of public international law.[17] Principles of public international law in relation to interpretation of two co-existing treaties and the nature of rights and obligations under each are aspects that then would need to be addressed. This paper, however, does not seek to examine a hypothetical case from each of these standpoints. Its limited focus is to address how the dispute settlement system may possibly address the issue of imposition of charges on imports based on the energy consumed during the production process. The aim of this assessment is to explore whether such a dispute would hold any possible 'solutions' that developing countries are seeking.

Before discussing these principles that allow space for environmental action, it is important to consider the threshold issue of how the US legislation or EU-ETS's carbon equalisation programme would be characterised under the WTO and the various provisions against which it is likely to be tested.

WTO Principles and Import Allowance/Carbon Equalisation Measures

The design of measures under the proposed US law and the EU-ETS Directive seek to impose costs on a foreign producer through an obligation to purchase emission allowances (as in the case of the US) or some sort of 'carbon equalisation' in the case of the EU. At the heart of these allowances/equalisation programme, is a charge/tax being imposed on imports based on the process of production – in this case, in respect of the energy used in the production process.

The provisions of GATT 1994 against which such a measure are likely to be addressed include:

Article II:1(b) which prohibits 'other duties or charges' in excess of those levied on the reference date, which are also required to be recorded in a country's schedule of commitments under the GATT.

[17] *United States- Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, May 20, 1996. Also see, *United States- Import Prohibition of Certain Shrimp and Shrimp containing Products*, WT/DS58/AB/R, where the Appellate Body referred to various principles from environmental agreements.

Article II.2(a), which deals with the nature of charges that may be imposed at the border, in order to create parity between like domestic products and imported products.

Article III.2 and ***Article III.4***, which deal with the principle of national treatment in respect of internal taxes and regulations as applicable to imported products.

Article XX, which deals with General Exceptions to GATT obligations, especially the exceptions in respect of environmental grounds under Article XX(b) and Article XX(g), which are likely to be invoked in arguments by any defending party to a dispute.

Further arguments can also possibly be framed under the WTO Agreement on Technical Barriers to Trade. This paper however does not seek to delve into TBT related aspects.

The past two years have seen the emergence of literature discussing one or more of these provisions.[18] What they reveal is that there is no unambiguous, definitive interpretation that is possible and that, if these provisions are actually applied, the dispute is likely to be highly contentious. The main principles in this regard will be highlighted in the discussion in this paper. To begin with, the basic provisions under GATT, 1994, relevant for this discussion are given in the box below.

Box 1: Provisions of GATT 1994 Relevant for Discussion on Carbon Border Measures

Article II Schedule of Concessions

1 (*b*) The products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date.

2. Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:

(a) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part…"

[18] Two recent reports provide an excellent summary of the existing literature in this regard: WTO-UNEP, *Report on Trade and Climate Change* (2009); and National Board of Trade, *Climate Measures and Trade*, (Sweden, February 2009).

Article III National Treatment on Internal Taxation and Regulation

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

Article XX General Exceptions

Subject to the requirement that such measures are not applied in a manner which would 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.

Charges on Carbon as charges in excess of that committed under a country's GATT Schedule

Article II:1(b) prohibits 'other duties or charges' in excess of those which are recorded in a country's schedule of commitments. Since charges in relation to the energy consumed in the manufacture of a product are not aspects that are incorporated into the schedule of commitments of any WTO member, the argument that could be developed is that such charges are against Article II:1(b) of GATT.

Charges on Carbon as a Border Tax Adjustment

GATT Article II.2 (a) allows WTO members to impose on the importation of any product a charge equivalent to an internal tax (e.g., a border tax adjustment or a BTA). The conceptual challenge to extending a BTA to imports based on the energy consumed in the process of production is whether BTA can be extended to components of energy (such as coal or oil) involved in the production process of an imported item, but which are not physically embodied in the product. Any tax or charge on energy

consumption would target the process or production method of the product in a foreign country.

An important source for understanding BTAs is the Report of the Working Party on Border Tax Adjustments, which was constituted in 1968 to understand the scope and application of BTAs. The Working Party defined a BTA as *"Any fiscal measure which put into effect, in whole or in part, the destination principle (i.e., which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products."*[19]

The Working Party's consensus was that such measures could be imposed in respect of *indirect taxes* imposed on domestic products; however, it did not comment on taxes in respect of energy consumed in a manufacturing process or on whether taxes have to be on inputs that are physically embodied in the final product.

Neither the GATT not the WTO dispute settlement bodies have had occasion so far to determine the issue. The only comparable precedent is the GATT Panel decision in the *U.S.-Superfund* case,[20] which involved US's Superfund Act under which the US levied taxes on imports of certain chemicals as well as end products of the chemicals. The amount of tax on any of the imported substances equalled in principle the amount of the tax which would have been imposed under the Superfund Act on the chemicals used as materials in the manufacture or production of the imported substance if the taxable chemicals had been sold in the United States for use in the manufacture or production of the imported substance.[21] With regard to the end products, the panel did not comment on whether these chemicals still had to be physically present in the imported product, since that was not one of the issues discussed.[22]

Applying principles of Article III on National Treatment: 'Internal Tax' under Article III:2

As noted above, Article II.2(b) provides that any charge applicable on imported goods has to be *equivalent* to an internal tax imposed consistently with the provisions of Article III.2. Article III.2 of GATT states that imported products shall not be subject to internal taxes *in excess* of those applied to domestic products.

The question in the context of the present discussions is whether the obligation for a domestic industry to participate in a scheme for undertaking emission reduction

[19] Report of the Working Party on Border Tax Adjustments, adopted on 2 December 1970, L/3464.
[20] United States- taxes on Petroleum and Certain Imported Substances, *Report of the Panel adopted on 17 June 1987 (L/6175 - 34S/136).*
[21] Id., Para 25
[22] For further discussion and analysis of this case, see Sheldon (2009)

obligations (as provided under the proposed US law or in the EU under the ETS), could be understood as equivalent to the requirement to pay an internal tax. Views are again conflicting in this regard. Some commentators are of the view that an emission-trading scheme cannot be equivalent to an internal carbon tax and doubt if such a wide interpretation of "tax" would be upheld in a WTO dispute.[23] However, it has also been observed that if the measures are designed in a manner such that the focus is on *auctioning* allowances, there would be a payment to the government, which would thus support an argument that such a measure is *equivalent* to a tax.[24]

In this regard, it is important to note that currently, both the proposed US legislation and EU-ETS have a significant component of *free allowances* for domestic industry. The US proposal, as highlighted above, also has provisions allowing companies to *bank* their allowances indefinitely for future use. How these elements are factored into the eventual pricing of allowances are likely to significantly affect the evaluation of whether or not these measures can be considered to be *equivalent* to a tax.

Applying principles of Article III on National Treatment: 'Internal Regulations' under Article III:4

Another critical limb of the national treatment principle is Article III.4 which addresses "all laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use" of products and mandates countries to ensure that such regulations should not treat imported products less favourably than domestic products.

The question that arises in this regard is whether the imposition of carbon emission norms and requirements for purchase of allowances, can be characterised as laws, regulations and requirements *affecting* a product that is *like* a domestic product, and whether such regulations *affect* the product in a manner so as to treat imported products less favourably than domestic products. The word "affecting" in Article III.4 has been interpreted by the WTO Appellate Body as having a "broad scope of application". In the *Korea – Various Measures on Beef* case,[25] the Appellate Body found that imported products are treated less favourably than like products if a measure modifies the conditions of competition in the relevant market to the detriment of imported products.

The principal impact of the EU and US legislations as outlined in Part I of this paper, is the differential treatment of physically *like* imported products, based on an assessment of the climate change related regulatory policies in the country of origin. The concept of *likeness* is also inherently acknowledged in the design of especially the US

[23] Howse and Eliason (2008)

[24] Swedish National Board of Trade (2009), citing De Cendra, "Can emissions trading schemes be coupled with border tax adjustments? An analysis vis-à-vis WTO Law", Review of European Community and International Environmental Law 15:2, 2006.

[25] WT/DS161/AB/R; WT/DS169/AB/R

legislation, which states as its rationale the need to address competitiveness concerns relating to the product. The extent to which the US and EC would be able to justify that their treatment of imported products is on *par* with regulations on domestic products and that it does not constitute *less favourable treatment* for imported products, will depend on the factual background and actual design and application of such measures. The EU-ETS, for instance, states that the carbon equalisation system would apply to importers *treatment that is no less favourable* than those applicable to installations within the EC. Whether the actual design and implementation of the measures treats importers in a less favourable manner would have an impact on assessing whether the WTO considers such treatment to be *less favourable* or not.

Existing analysis of the US legislation acknowledges that application of the law could constitute, *prima facie*, discrimination between like imported products and domestic products.[26] There is also the view that by designing the measures in a manner that extends concessions and free allowances that are available to the domestic industry to imported products as well, it may be possible to show that there is no less favourable treatment of the group of imported products to the group of like domestic products.

Article XX- General Exceptions to GATT Obligations

Whatever is the actual characterisation of such measures, and assuming that there is a likely finding of violation of basic GATT principles, the defending party would seek likely justification for such measures on the basis of the General Exceptions to GATT obligations specified in Article XX. Both the US legislative proposals and the EU-ETS specify that their action against third-country importers would depend on the outcome of international negotiations on this aspect. This seems to be a fallout of a key WTO Appellate Body ruling on the use of Article XX in the *US-Shrimp-Turtle* case,[27] which emphasised the need for finding multilateral solutions before resorting to unilateral action.

At the outset, it must however be emphasised that jurisprudence under Article XX that has emerged so far deal with measures which have been *applied*. Any ex-ante assessment based on the current state of understanding of the US and EU legislative measures will, therefore, be limited only to highlighting possible issues for consideration in a potential dispute scenario.

As explained above, Article XX deals with 'General Exceptions' to obligations under the GATT. Two exceptions are of particular relevance to the protection of the environment: paragraphs (b) and (g) of Article XX. According to these two paragraphs, WTO members may adopt policy measures that are inconsistent with GATT disciplines, but which are:

[26] See, for example, supra n.3

[27] *United States- Import Prohibition of Certain Shrimp and Shrimp containing Products*, WT/DS58/AB/R

- Art. XX(b): "necessary to protect human, animal or plant life or health"; or
- Article XX(g): "relating to the conservation of exhaustible natural resources."

The ability to pursue the policies listed under Article XX is, however, limited by the chapeau to Article XX, which states that the availability of these exceptions is "s*ubject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade".* As discussed above, the wording of Article 3.5 of the UNFCCC reflect the language of the chapeau to Article XX of GATT.

An Article XX assessment involves a two-step process: (a) the first step addresses whether a measure can be provisionally categorised under one of the exceptions of Article XX, in this case (b) and (g). The second step involves assessing the application of such measures under the tests specified in the chapeau to Article XX (in italics in the preceding paragraph).

There have been several prominent disputes at the WTO dealing with the trade and environment interface under Article XX(b) and (g).[28] A few basic propositions that emerge from these rulings are as follows:

- WTO law does not exist in clinical isolation of international law and developments, including environmental concerns. However, trade restrictions on environmental grounds can be adopted only under certain strict conditions.
- Tests of *necessity* and availability of *less trade restrictive measures* need to be applied prior to application of any trade restriction on environmental grounds.
- Multilateral solutions to environmental issues are the preference; a WTO member should, therefore, make *serious efforts to negotiate* such solutions. If despite such efforts, an agreement cannot be concluded, then trade measures for protection of environment may be taken, even outside that country's jurisdiction.
- Lack of flexibility in taking into account the different situations in different countries amounts to unjustifiable discrimination.

Applying Article XX to the U.S. Bills & EU-ETS

As pointed out in the introductory section and in Part I of this paper, the primary rationale articulated in US and EU legislations are two-fold: (a) addressing ***leakage*** issues and (b) addressing ***competitiveness*** concerns. Any Article XX justification would need to be rooted in the former; since the latter is likely to be viewed as

[28] *United States- Standards for Reformulated and Conventional* Gasoline WT/DS/1 (20 May 1996); *United States- Import of Certain Shrimp and Shrimp Products* WT/DS/58 (6 Nov., 1998), *United States- Import of Certain Shrimp and Shrimp Products- Recourse to Article 21.5 of the DSU,* WT/DS/58 (21 Nov. 2001); *Brazil- Retreaded Tyres, Measures Affecting to Imports of Retreaded Tyres,* WT/DS332/AB/R.

protectionism for the domestic industry. There is no provision in Article XX that would justify a measure based on competitive disadvantages being faced by a domestic industry.

While leakage issues have not been addressed under Article XX before, *clean air* has been held to be an exhaustible natural resource for the purposes of Article XX(b) in the *US-Gasoline* case.[29] While both Article XX(b) and (g) are likely to be relevant in any justification of a carbon border measure, it is important to highlight that Article XX(g) is focused on '*conservation'* as a goal. This focus on conservation, however, does not come through clearly in the design of US legislations or the EU-ETS, and this is a possible argument against invoking an Article XX(g) exception that would likely be argued by countries challenging such measures.

The next step would be to establish a clear relationship between the design of the measure and its objectives, i.e., whether they are necessary or sufficiently related to the reduction of greenhouse gas emissions. A substantial relationship between the measure and its objectives are cornerstones of any Article XX analysis. The Appellate Body in *Brazil-Retreaded Tyres*,[30] while assessing the *necessity* test under Article XX(b), has observed that a measure's "contribution to the achievement of the objective must be material, not merely marginal or insignificant."[31] One of the ways in which "necessity" has been addressed in cases is to assess whether less trade restrictive alternatives are reasonably available.

In this regard, findings in existing literature that conclude that unilateral emission cuts by countries will have minimum leakage implications,[32] could possibly be considered by countries seeking to challenge such measures. An assessment of the *effectiveness* of the measures contemplated in addressing the underlying environmental objectives under Article XX(b) or (g), is likely to play an important role in any potential WTO dispute.

Assessing Extra-Territorial Application of such Measures

The primary focus of both the US legislative proposals and the EU-ETS is not the environment within their territories alone. Carbon leakage signifies a situation of deteriorating environmental conditions outside of the domestic jurisdiction of a country. The immediate question that arises in this regard is whether countries have the right to address carbon leakage through unilateral measures to address environmental concerns outside of one's territory, unless this is supported by multilateral consensus on the use of such unilateral measures.

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[29] *United States- Standards for Reformulated and Conventional* Gasoline WT/DS/1 (20 May 1996).
[30] *Brazil- Retreaded Tyres, MeasuresAffecting to Imports of Retreaded Tyres,* WT/DS332/AB/R.
[31] *Id,* Para 210.
[32] *See,* supra n.4.

In the *US-Shrimp Turtle* case, a key issue that was addressed was whether Article XX can be used to justify extra-territorial environmental concerns. The reasoning in this case, which was based on Article XX(g), is arguably the most significant ruling that could potentially shed some light on a possible WTO treatment of carbon border measures as well. The case involved a US measure that conditioned market access for shrimps into the US, based on an assessment of whether the exporting member had regulatory mechanisms to ensure that the shrimps were caught by trawlers that used "turtle excluder devices" (TEDs) in their nets. Such a measure, clearly, was a unilateral prescription by the US of regulatory mechanisms in areas beyond its jurisdiction.

In its report, the Appellate Body made clear that trade measures on grounds of protection of environment (in particular, human, animal or plant life and health and protection of endangered species and exhaustible resources), would be justifiable under Article XX provided certain criteria such as non-discrimination were met. The US lost the case because it was found to discriminate between WTO members. This finding was based, among other relevant facts, on the fact that the US had concluded an international agreement with the Caribbean countries to address the issue of use of TEDs by shrimp trawlers but not with other countries. Such selective action vis-à-vis other WTO members was found to run counter to the principles of the chapeau to Article XX that require non-arbitrary and non-discriminatory action. The Appellate Body emphasised that a WTO member's action should focus on multilateral solutions to implement environmental concerns.

The Appellate Body also found that the requirements under US law which required the exporting country to have the *same* legal requirements as that of the US amounted to 'arbitrary discrimination' under Article XX, since they mandated that countries should have regulatory schemes that are "essentially the same" as the US programme, without inquiring into appropriateness of that programme for the conditions prevailing in the exporting countries.[33]

What is of greater significance is the analysis by the WTO Appellate Body of US action under a subsequent proceeding regarding implementation in the same case.[34] This proceeding was initiated by Malaysia (which was one of the original complainants along with India), which sought to argue that the US had failed to implement the WTO ruling. Malaysia argued that "arbitrary and unjustifiable discrimination" under the chapeau of Article XX required the *conclusion* of an international agreement, and that the US had not achieved this. The Appellate Body upheld the implementation panel's finding and rejected Malaysia's contention, based on its reasoning that the test of non-arbitrariness and non-discrimination under the chapeau to Article XX did not require the *conclusion* of an international agreement; but that this test would be satisfied if the

[33] Para 161-164, 177, of the AB Report.

[34] WTO Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products – Recourse to Article 21.5 of the DSU by Malaysia* ("*U.S. – Shrimp (Article 21.5 – Malaysia)*"), WT/DS58/AB/RW, adopted 21 November 2001, DSR 2001:XIII, 6481.

US could demonstrate that it had made 'serious efforts' to negotiate.[35] The Appellate Body did not go into reasons why an international agreement could not be concluded, and whether there were reasons relating to inflexible negotiating position or lack of consensus because of a wider array of issues. Importantly, the Appellate Body also held that it is open to an importing country to require exporting countries to adopt regulatory programmes that are "comparable in effectiveness" to the importing country.[36]

Specific Issues under the US Bills and EU-ETS

Each of the issues highlighted in Part I of this report regarding the main concerns of the US legislative proposals and the EU-ETS are aspects that will need to be highlighted in a potential WTO dispute. The main concerns highlighted in Part I of this report are being summarised here for quick reference:

Concerns under US Bills

The main concerns with the US bills are aspects relating to the following:

- Criteria for determining 'major emitting countries';
- Assessment of whether an international agreement arrives at "equitable" GHG reduction obligations;
- Structuring of exemptions from the reserve allowance programme, i.e., requirements that a third country should be subject to GHG emissions reduction commitments that is *at least as stringent* as that of the United States; or that country has an *annual energy or greenhouse gas intensity for the sector that is equal to or less than* the energy or greenhouse gas intensity for such industrial sector in the US

Concerns under EU-ETS

The main concerns with the EU-ETS are the following:

- Manner in which EU makes an assessment that an international agreement does not take into account its negotiating objectives as outlined in the revised EU-ETS directive; and
- Criteria for assessing comparable action for 'economically advanced developing countries' under EU-ETS.

While any ex-ante assessment will not be able to definitively answer these questions, it is clear that any dispute would be a highly contentious one. The question that arises is whether leaving the decision to the WTO is a real option at all, or whether this should be pre-empted by driving towards greater clarity within the UNFCCC framework itself. In this regard, the next section will examine some of the textual formulations on trade and climate change that are being considered currentlyat the UNFCCC.

[35] Ibid., para 133-134
[36] Ibid., para 143-144.

III Textual Considerations on Unilateral Trade Measures under the UNFCCC Discussions

As discussed in Part II.A of this paper, the UNFCCC envisages the possibility of use of 'unilateral measures' in Article 3.5. While Article 3.5 is silent as regards the circumstances when unilateral measures can be used by a party, it specifies two safeguards against such use, which are worded in broad terms similar to the chapeau of Article XX of the GATT. It states that such measures should not *(a) constitute a means of arbitrary or unjustifiable discrimination* or *(b) be a disguised restriction on international trade.*

As discussed earlier in this paper, Article 3.5 potentially leaves open a wide policy space for unilateral action. The negotiating texts for COP-15 (Copenhagen, December 2009) and COP-16 (Cancun, December 2010) included discussions on options on the issue of unilateral trade measures under Article 3.5. The highly contentious nature of the discussions and the tenuous nature of textual changes being considered are reflected in the versions that have emerged out of the discussions. The issue remains unresolved, and is expected to form a part of the negotiating texts for the COP-17 at Durban, South Africa in late 2011.

The negotiating text considered at Cancun[37] specified four different alternatives on unilateral trade measures, each of which reflects the sharp contrast in positions between developed and developing countries.[38] Additionally, there is a place-holder wherein G-77 and China have indicated their right to propose new text. The four alternatives are summarised in the Box below.

Box 2: Negotiating Text Relating to Article 3.5 of UNFCCC

Alternative 1:

[Developed country Parties shall not resort to any form of unilateral measures including tariff and non-tariff, and other fiscal and non-fiscal border trade measures, against goods and services imported from developing country Parties, on any grounds related to climate change. **Such measures would violate the principles and provisions of the Convention, including, in particular, those related to the principle of common but differentiated responsibilities (Article 3, paragraph 1), to trade and climate change (Article 3, paragraph 5) and to the relationship between mitigation actions of developing country Parties and the provision of financial resources and technology by developed country Parties (Article 4, paragraphs 3, 5, 7, 8, 9, and 10)]**. *(Emphasis added).*

[37] Note by the Secretariat, Advance Version of the Negotiating Text, FCCC/AWGLCA/2010/14, Ad Hoc Working Group on Long-term Cooperative Action under the Convention Twelfth session, Tianjin, 4–9 October 2010.

[38] The Negotiating Text does not indicate which country has authored a specific alternative; but this can be discerned from the intent and focus of the specified alternative.

Alternative 2:

[Recalling the principles and provisions of the Convention, in particular Article 3, paragraphs 1, 4 and 5, and Article 4, paragraphs 3, 5 and 7, and **taking into account the principles of equity, common but differentiated responsibilities and the obligation of the developed country Parties to provide financial resources, development and transfer of technology and provide capacity building support to the developing country Parties, the developed country Parties shall not resort to any form of unilateral measures**, including tariff and non-tariff or other fiscal and non-fiscal border trade measures, against goods and services from developing country Parties on any grounds related to climate change, including protection and stabilization of climate, emissions leakage and/or cost of environment compliance.] *(Emphasis added).*

Alternative 3:

[That, taking into account the relevant provisions of the Convention and **further recognizing the principle enshrined in Article 3, paragraph 5, Parties in the pursuit of the objective and implementation of the Convention, shall not resort to any measures, in particular unilateral fiscal or non-fiscal measures applied on the border, against goods and services imported from Parties, that constitute a means of arbitrary or unjustified discrimination or a disguised restriction on international trade**.] *(Emphasis added).*

Alternative 4:

[**In accordance with Article 3, paragraph 5, measures taken to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade**.]

(a) bis [That the social and economic cost derived from climate change mitigation response measures shall not be passed on to developing country Parties through any means, including trade-related measures, in accordance with Article 3, paragraphs 1 and

5 of the Convention, and stresses the importance of the provision of finance and technology by developed country Parties, in accordance with Article 4, paragraphs 3, 5 and 7 of the Convention.] *(Emphasis added).*

The impact of the these alternatives can be summarised as follows:

- Alternative 1 is worded as an obligation on developed country parties *not* to resort to any unilateral measures on grounds of climate change, and is then backed up with an interpretational clause in the second sentence that any such unilateral measures would "violate the principles and provisions of the Convention". It is, however, silent on what kind of unilateral measures would be possible in practice under Article 3.5, thereby leaving the space open for arguments on what kind of unilateral action would be justifiable.
- Alternative 2, although also worded as a prohibition on unilateral action, links developed country action to obligations to provide financial resources and transfer of technology and capacity building, thus arguably creating some space for

unilateral action in the event such obligations are fulfilled. However, the inherent ambiguities in this formulation are the absence of criteria for determining whether a developed country is adhering to its obligations to providing financial resources and capacity building.

- Alternatives 3 and 4 are simply a re-statement and a reiteration of Article 3.5 of the Convention, and do not add any substantive aspect to it. Sub-clause (a)*bis* to Alternative 4 has an additional sentence on how the social and economic costs of climate change mitigation measures shall not be passed on to developing country parties. The actual interpretation and implementation of this provision is, however, unclear because of the inherent ambiguities in determining what the "social and economic cost derived from climate change mitigation', could be.

What is particularly striking about each of the alternatives set forth above, except for Alternative 1, is that they do not clearly state that unilateral action against parties adhering to their obligations under the Convention, would undermine the basic principles of the UNFCCC. Moreover, none of the alternatives highlight the circumstances under which unilateral measures under Article 3.5 can actually be exercised. It is important to consider this because Article 3.5 of the UNFCCC clearly recognises that some form of unilateral action would be considered legitimate, but as discussed earlier, it does not lay down the principles or framework for exercise of such action. Instead of countries individually legislating on this aspect, a case would need to be considered for the UNFCCC, or any protocol envisaged under it, to become the locus where the circumstances under which such action can be taken are clearly articulated.

Trade Measures under International Environmental Law Instruments

In this regard, it would be useful to briefly examine two other international environmental law instruments that specify trade-related measures: the Montreal Protocol on Substances that Deplete the Ozone Layer and the Convention on Trade in Endangered Species (CITES). Both provide a clear framework for multilateral principles for exercise of trade measures. In both these cases, the exercise of such trade measures is not a 'unilateral action' in the strict sense of the term, but rather actions of a party sanctioned through the multilateral processes as outlined in these instruments. Nevertheless, the basic principles for exercise of such measures provide valuable pointers to how the use of trade measures for environmental purposes needs to be streamlined.

Montreal Protocol

The 1987 Montreal Protocol on Substances that Deplete the Ozone Layer was concluded under the framework of the Vienna Convention for the Protection of the Ozone Layer. Trade measures were incorporated in the Montreal Protocol both as an incentive to encourage countries to participate in the measures to protect the ozone layer and to provide a framework within which countries could have access to ozone-

depleting substances during their transition periods. Measures restricting trade with non-parties were incorporated to ensure that such non-parties do not secure an economic or trade advantage over parties. With regard to parties to the Protocol, measures for non-compliance could be arrived at only through multilateral consultations. Article 8 of the Protocol requires parties to consider and approve procedures and institutional mechanisms for determining non-compliance with the provisions of the Protocol and for treatment of parties found to be in non-compliance. The Copenhagen Amendment to the Protocol concluded in 1992 laid down the non-compliance procedure and the list of measures that the Conference of Parties may take against one of the parties found to be in non-compliance. This includes trade measures. The important point to be noted is that no unilateral action is envisaged for non-compliance by a party to the Protocol. Any action for non-compliance, including any trade related responses, are to be taken only at the Meeting of the Parties. *CITES*

The focus of trade measures in CITES is two-fold: (i) controlling trade in endangered species and (ii) specific trade measures in the form of ban on imports from parties or non-parties who are unwilling to implement the convention. Such specific trade measures are based on an evaluation by the COP on whether a country's legislation is inadequate to implement the provisions of the CITES.

Recommendations to suspend trade in specimens of CITES-listed species are made by the COP and the Standing Committee. A recommendation to suspend trade provides a period of time during which the relevant country can move from non-compliance to compliance by, *inter alia,* making progress in the enactment of adequate legislation, combating and reducing illegal trade, submitting missing annual reports or responding to specific recommendations of the Standing Committee concerning the implementation of Article IV of the Convention. Recommendations to suspend trade are withdrawn immediately upon a country's return to compliance.

Like the Montreal Protocol discussed above, CITES' approach to trade measures also stems from a multilateral determination regarding compliance. This brief overview of CITES and the Montreal Protocol are only meant to provide examples of how other multilateral environmental agreements have addressed trade concerns. Both emphasise the principle for trade measures against non-parties or against parties for non-compliance, but do not allow for such measures unless the procedures prescribed under the agreements for multilateral evaluation have been satisfied. In other words, neither envisages the space for any unilateral action. Another significant element in both instruments is that they envisage "trade measures" only as a last resort for enforcing compliance.

IV Way Forward in UNFCCC Negotiations

Disagreement on the overall architecture of rights and obligations under the UNFCCC would enhance the possibility of exercise of unilateral trade measures. Any such action would undermine the basis of a multilateral system. It is, therefore, important to

consider ways of circumscribing the possible use of unilateral measures under Article 3.5 of the UNFCCC.

With a view to reaching a conclusion on the way forward, I seek to elaborate below the principal aspects discussed in this paper.

1. Not having an international agreement to address the issue of climate change is fraught with various risks. Apart from the fact that a problem of such a global scale requires multilateral solutions, absence of an international agreement would enhance the risk of unilateral action. Such action is already being contemplated in legislative attempts in the US and the EU. While the design of such measures is as yet not completely clear, their focus is that action against imports may be triggered if it is found that there is lack of comparability in emission reduction obligations in exporting country with those in importing countries. Such an over-arching principle would defeat the purpose and spirit of the principle of common but differentiated responsibilities that are currently enshrined under the UNFCCC and the Kyoto Protocol.[39] The first imperative, therefore, is to have an international agreement.
2. Having an international agreement where a country's desirable objectives have not been fully met could also potentially be used as the basis for unilateral action. The emphasis in the proposed US bills and the EU-ETS on what they perceive as desirable elements of an international agreement (where potentially developing countries too have emission reduction obligations) highlights the possibility that having an international agreement in itself is not sufficient safeguard against unilateral action. Any international agreement, therefore, would have to have sufficiently clear principles on when a party may exercise unilateral action.
3. Unilateral action is not prohibited by the UNFCCC; in fact, Article 3.5 of the UNFCCC contemplates such action and simply subjects such action to the caveat that it should be non-discriminatory and not constitute a disguised restriction on trade. In the absence of a multilateral agreement clarifying the basis on which such action may be triggered, the circumstances for such action could be debatable and left open to interpretation.
4. It is important to examine the debate on unilateral action in the context of the subtle shifts in the balance of rights and responsibilities as reflected in the Copenhagen Accord and the Cancun Agreements, which seem to emphasise a greater degree of responsibility on developing countries. This is in contrast to the overall balance of rights and obligations under the UNFCCC, which includes provisions that make developing country action conditional on technical and financial assistance.
5. It is clear that any unilateral trade measure taken on the pretext of climate change concerns, is likely to be challenged at the WTO as violating the basic principles of

[39] As discussed in this paper, there are several differences in the approaches of the US and the EU. The EU-ETS, in fact, emphasises that any action would 'take into account' the CBDR principle of the UNFCCC. The actual design of such measures would be the ultimate test of their impact.

the GATT, and perhaps other WTO Agreements such as the Agreement on Technical Barriers to Trade. The design and actual implementation of such measures will, to a large extent, determine the ultimate assessment of WTO consistency of such measures. Nevertheless, preliminary examination of the basic principles against which such measures are likely to be tested reveal that such a dispute will throw up a range of new conceptual issues and challenges for the WTO dispute settlement mechanism. There are arguments possible both for and against such measures, including those regarding the possible justification of such measures as an exception to principles under GATT, especially when there is a state of disagreement on the multilateral framework. Any such dispute is also likely to consider the provisions of the UNFCCC and developments under the UNFCCC.

6. Moreover, while the time-bound WTO dispute settlement system with adequate provisions for enforcement is one of the most significant achievements of the WTO, there are a few limitations in the process. For example, any potential finding of invalidity of such a measure would only affect the measure prospectively and there is no room for compensation or damages for past action. It could take up to two years or more, from the time of initiation of WTO dispute settlement, for a decision. Bringing a case before the WTO may, therefore, not be a panacea.

With a view to achieving clarity, it would be important to consider the conditions that necessarily have to exist for the exercise of any unilateral trade measures within the context of the climate change negotiations. In this regard, it can be argued that, if under the ongoing negotiations, there is a satisfactory agreement on reduction commitments for the period post-2012, a strong case could be considered for modifying Article 3.5 of the UNFCCC to clarify that no party to a binding protocol under the UNFCCC can take any unilateral trade measures related to climate change against another party to such a protocol. Such unilateral measures should be confined only to non-parties to such a Protocol.

However, it must be acknowledged here that given the present positions at the UNFCCC negotiations, the chances of securing an outright ban on unilateral measures are not very high. The developed country parties are not likely to give up a right that they have acquired in past negotiations, howsoever justified the rationale might be.

In view of this, what can be done realistically is to minimise the need and opportunity for use of unilateral trade measures. For this too, the first imperative would be to have a satisfactory agreement on reduction commitment for subsequent periods as envisaged in the Kyoto Protocol. Trade measures within the framework of a binding agreement/protocol, should be confined only to purposes of enforcement and compliance, for which multilateral procedures would need to be developed. Such procedures could envisage trade measures as a last resort to enforce compliance, but

only on the basis of multilateral scrutiny and approval through a mechanism, which should include the following features:

- The procedures should provide for multilateral determination of non-compliance followed by multilateral authorisation of measures to obtain compliance, according to the precedent set by the Montreal Protocol and the CITES.
- The multilateral procedures should provide for transparency, reporting, surveillance, consultation, arbitration and dispute settlement elaborately designed to ensure that members implement their obligations.
- Trade measures should be the last resort for multilateral authorisation after all other steps have failed to obtain compliance.
- Trade measures to obtain compliance should be envisaged only against non-compliance with substantive obligations on reduction targets and should not be authorised for procedural shortcomings.
- Should the elements for International Consultation and Analysis (ICA) and criteria for measurement, reporting and verification (MRV) of nationally appropriate mitigation actions, as envisaged under the Cancun Agreements, be converted into elements of a legally binding agreement, the remedy for non-compliance should not be trade measures.

While it may not be possible to eliminate the possibility of unilateral action, a strong multilateral framework is more likely to confine the limits of any action to an agreed set of principles.

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Core - 6A, 4th Floor, India Habitat Centre,
Lodi Road, New Delhi - 110003
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