

**Joint Japan-U.S.A. Study Group on Mutual Supportiveness  
Of the Environmental Protection and the Economic Growth**

**On the Flexibility Mechanisms  
And Developing Countries' Participation**

Talking points for session 1, 2 and 4

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Mitsutsune YAMAGUCHI  
KEIO University  
Fax: 81-3-3798-7480  
e-mail:myamagu@econ.keio.ac.jp

## Session 1: Annex B trading issues

### Preface

#### Importance of Kyoto Protocol: First step to cope with Climate Change

U.S. ratification is essential. We appreciate the U.S. assertion that some kind of developing countries' commitment is a prerequisite for the ratification of the Protocol. We share the same view that without developing countries' cooperation, it is impossible to cope with climate change. By the same token, in view of large U.S. GHGs emission (both in volume and on a per capita basis), we would like to see the U.S. decisively manage domestic measures to reduce GHGs. The reason is that in Japan, as I will touch upon later, it is almost impossible to comply with the protocol if we rely only upon the flexible mechanisms. In Japan, Domestic policies and measures will, I am quite sure, play a major role to cope with global warming.

We would like to hear from you as to your experiences on SO<sub>2</sub> emission trading under the 1990 Clean Air Act Amendment and the possibility of applying it to domestic GHGs' emission reductions. The U.S. is the only country so far that has introduced a large scale SO<sub>2</sub> emission trading scheme successfully.

### 1. Emission Trading

#### 1) Promotion of Emission Trading

•The biggest barrier for establishing an emission trading scheme, i.e. the dispute over initial allocation, has already been removed, though it is necessary to review this in the second budget period from the standpoint of efficiency and equity.

•Therefore maximum utilization of this mechanism among Annex B countries should be expected. For this purpose, there are several points to clarify; the Hot Air, Supplementarity, Liability, and Market Power issues are among those that should be dealt with at the coming COP(s).

#### 2) Hot Air

•Suppose that the hot air exists in some Annex B countries and they are not allowed to sell that portion. Under these circumstances, if other Annex B countries comply with their commitments, the reduction due to the hot air portion will be in addition to reductions made by Annex B countries.

•Under the above supposition, if countries with hot air are allowed to trade that portion, the total reduction amount of Annex B countries will be smaller by the traded hot air portion in comparison to the case where hot air trade is not allowed. But even in this case it is noteworthy that Annex B countries as a whole can comply with their commitment under the Kyoto protocol.

•If there exist country(ies) that has hot air (due to economic stagnation), it is those countries who need international assistance for their economy to re-bound. Money inflow to those countries in the shape of emission trading should be most welcomed by international society.

•Another difficulty in eliminating hot air trade is how to know, in practice, what part of emission reduction is due to the hot air (Monitoring Issue).

### 3) Supplementarity

•Yes, we have agreed to utilize the Emission Trading scheme as a supplement to domestic actions to meet QELROs. There is no doubt that domestic policies and measures should come first.

•Having said that, it is also true no definition is agreed as to what “supplemental” actually is. Shouldn’t the portion of reduction by domestic P&Ms exceed 50%?

•It is my understanding that the “best effort” will be taken to reduce GHGs emissions domestically, with the remaining portion, if any, being fulfilled by utilizing the “mechanisms”.

•As for Japan, concern over supplementarity will be quite groundless. Our BAU estimate shows a 20-25% increase in comparison to our 1990 emission figures and our estimate of reduction due to Emission Trading is less than 2%. No one would argue about supplementarity in this case. I would like to know about U.S. estimates on this point. If the situation is the same for most Annex B countries, further discussion on the supplementarity issue is meaningless.

### 4) Seller/Buyer Liability

•Interests will conflict on this issue according to whether a country will be a potential seller or buyer. The former prefers buyer liability and vice versa. What we need is an objective criteria for comparison at the discussion. The criteria should be that which is better for the purpose of the Kyoto protocol.

•Under buyer liability, a good point is that countries that wish to sell should pay the utmost attention to observe their obligation. Otherwise, the price of their tradable permits will be devalued. This is what happens in a monetary market. Moody’s or the S&P will publish their ratings of Annex B countries’ permits, and for lower graded permits, prices will be forced to decrease. As a result, the buyer liability scheme will ensure that the total emission amount will not exceed the allocated amount of both buyer and seller. However as seen in the monetary market, once an equity or bond is ranked as junk status, this means those bonds are actually blocked out from the market. This means that the buyer liability scheme potentially involves risks that trade itself will shrink. Here we have to remember the fact the Kyoto protocol was agreed on the assumption that emission trading will be introduced and can be utilized whenever it will become necessary (with the restriction of “supplementarity”). From this point of view, buyer liability contains inherent risk that major players will become unable to comply with their QELROs and, as a result, the Kyoto protocol itself, an important first step toward mitigating climate change, will be on the verge of extinction.

•Based on the above discussion, seller liability will serve better for sustainable development.

### 5) Establishing Efficient Markets

#### a) Participation of private enterprises

In order that market works most efficiently, it is desirable as many players as possible can participate in the Emission Trading market. In this regard, participation of private enterprises as well as NGOs and other organizations is most welcome.

In a competitive market, the price of tradable permits will be set at the point where marginal GHGs abatement cost equalizes throughout all participants. It is the private enterprises that know their marginal abatement costs and not Governments. In this sense, we should never prevent private enterprises from actively participating in the market, provided that immediate reporting to their respective countries is a necessity.

There will be countries which do not allocate their allowances to domestic enterprises. In this case, private entities' rights to sell shall be restricted to the extent they purchase at the market (or acquire through projects admitted as Joint Implementation &/or CDM).

#### b) On Anti-Competitive Practices

According to the draft paper presented at the expert meetings of OECD last March, the total volume of GHGs trade is calculated as 410 million carbon tons and the value is estimated at about \$20 billion. This is enough volume and value to form a market where not only "spot" but various financial products such as forward, swap, option and futures emerges. For enterprises that make decisions whether to invest or not taking into consideration the future price of the tradable permits, to have such a variety of products is a good thing to hedge their risks. However, as the market grows, there will be room for international speculators to come in and the market will be attacked on a large scale.

It is expected that there will be many purchasers and a few sellers, at least in the first stage of trade, in the market. We have to pay attention to avoid any unfair trade, i.e. cases where factors other than pricing will influence the trade. For this purpose, it may be necessary for transactions between (two) Governments to ask the seller/buyer to disclose the price of traded permits. Another way is to force Government(s) to sell only by auction.

In any case, transparency of the market and transaction rules is definitely required.

So far, not so many experts in the financial field are involved in the discussion. However, in view of the above, it is time for us to ask them to join in to find out ways of avoiding any distortion to the market.

## Session 2: Presentations on CDM issues

### Preface

We should promote CDM for the sake of both developed and developing countries.

One of the most noteworthy characteristics is that CDM includes both technology and fund transfer to developing countries.

How to keep transaction costs at a reasonable level is the key point for promoting CDM projects.

Also we have to keep in mind developing countries' cautiousness or reluctance for CDM. It is necessary for us to look at this mechanism from the view point of developing countries.

### 1) Transaction Costs

There are so many factors and uncertainties that make transaction costs too expensive. They are: operational entities' expenses (including monitoring costs), contribution to the most affected countries, baseline calculation, monitoring, etc.

To make the costs reasonable, operational entities' cost should be kept to a minimum. For this purpose it is suggested to have more than two entities in competition.

From our experience of AIJ projects, a lengthy negotiation sometimes seems unavoidable. For example, how we take technological innovation into consideration in calculating baseline emissions becomes a hot issue, as well as to what extent of indirect effect we should count.

To overcome the above, we have to pursue common standards for calculating baseline emissions and also reduction quantities of GHGs for which Parties to the Kyoto Protocol agree upon. For this purpose, standards will be prepared on a sector by sector basis (Just to avoid any misunderstandings, let me add that any parties concerned have the freedom not to follow the standard if they have enough reason to do so). We have in total 78 AIJ projects registered to the secretariat of the FCCC as of June this year, which include various projects such as improving energy efficiency, fuel switching, renewable energy, forestation/reforestation etc. Analysis of those projects by the secretariat of the FCCC or such an institution as OECD will definitely help, as a first step, to having standards that will be acceptable to all countries concerned. Otherwise it is we, Japanese and U.S. economists joined by other experts from other parts of the world, who should consider cooperating to work out standards.

Monitoring is another concern. To share credits, we need to know the exact amount of GHGs reduction. To have objective monitoring results, it may be necessary to have several certification bodies internationally accredited.

### 2) ODA and CDM

We now turn to examine a role of the Official Financial Flow with respect to CDM projects. Needless to say, not only the amount of Official Financial Flow and its proportion to GDP differ from country to country, but also Governments' policies towards assistance for developing

countries are quite different (Just think about the U.S. Foreign Assistance Act and U.S. aid towards communist countries). Also tying status in relation to ODA is apparently different. In spite of those differences, I would like to discuss a basic principle here as to whether it is justified to count a joint project made possible by, say, ODA as being qualified as CDM.

Under decision 5/CP.1, it is clearly stated that in order to be qualified as an AIJ project, a precursor to CDM, financing of AIJ shall be additional to the financial obligations of Parties. Therefore a joint project utilizing current ODA flows is unqualified as AIJ just because of a lack of financial additionality. However, there are several commercially based projects registered as AIJ, especially those cases involving the U.S. utility sector. And under Article 12 of the Kyoto protocol, financial additionality is not a precondition for CDM anymore. What I would like to explain here is that leaving financial additionality out from CDM preconditions is beneficial not only for developed countries but also for developing countries.

The ODA amount is not increasing and the ratio of ODA amount against the world total financial flow to developing countries is decreasing rather drastically. Among other things what is remarkable is that the ODA amount of Japan, the world's biggest donor, in 1996 decreased by 35% on a U.S. dollar basis. Though some portion of the decrease is attributed to devaluation of the Yen against the dollar, the declining tendency of ODA amount is universal. Especially in view of the current world economic situation, no one can expect the trend will be reversed in the near future. Most of the developed countries now face pressure to reduce ODA amount (or portion) so that the money can be used for domestic economic measures.

Under this situation, developed countries' governments have good reasons not to reduce their ODA amount if they can persuade their people that ODA funds used to assist developing countries can be of benefit to themselves as they can acquire credits. On the contrary, if developing countries insist on financial additionality and refuse to admit any ODA projects as CDM, it will be they who suffer from a decrease of ODA flow from developed countries.

Especially under the current economic turmoil, direct investments to developing countries from developed nations are vital for their economies. CDM is scheduled to be introduced from the year 2000 (though we are not sure we can reach agreement in detail, and whether such organization as operating entities will really be workable by that time). Therefore to have common understanding that the ODA projects (and also other purely commercial projects) are eligible for CDM is the best solution for all parties concerned.

There remain many things to be determined, however. Just to mention one example, for untied loans cases, host countries will purchase various materials from various countries. To whom does the credit belong, to the donating country or countries that export machinery to host countries?

### 3) Measures to promote CDM

Generally speaking, to provide as much information as possible will be useful to all parties concerned. In this respect the ideas of the CIF (Carbon Investment Fund) and IBES (International Bank for Environment Settlement) are worth studying, though we have to pay careful attention to whether the cost of managing those organizations exceeds the benefit they bring in.

•Another useful way is to carry out a study into existing AIJ projects to find out what kind of projects are the most cost effective. For this purpose international cooperation in the academic field is most welcomed.

•A third way is to provide as many ways to avoid risks of not obtaining CDM credit. There will be two kinds of risks. One is the risk that, due to an act of God or some other sudden and accidental incident, a project itself suffers physically. For example, if a plant were destroyed by an earthquake, developed countries (or more precisely, corporations of developed countries) will be unable to acquire anticipated credits. The second risk is that, though there is no accident, the completed projects will not show satisfactory performance, i.e. reduction of the GHGs is quite different from what is expected. The former risk could be covered by commercial insurance market. But for second one some kinds of risk hedge devices, probably with the public authorities' participation, should be invented.

•As stated above, there is no provision that prohibits commercial projects to be qualified as projects under CDM. To make this point clear through negotiation at coming COPs will promote additional GHGs reduction investment from developed countries.

•For developing countries, it will be beneficial to clarify that the credit of their portion can be sold on the emission trading market or banked for their future sales.

## Session 4: Developing countries participation

### 1) General View

The Kyoto protocol is an important step toward limitation and reduction of GHGs emissions. But it is just the first step. In view of the prediction that, in the year 2010, developing countries' emissions will exceed that of developed countries, it is certain that all the Parties must assume some kind of obligation. The problem is how and when.

### 2) Concept of Voluntary Participation and Evolution

Before and during the Kyoto meetings, the above two concepts were discussed unsuccessfully. Voluntary participation means to welcome any country to accept voluntarily the QELROs. The new entrants would be able to trade their emission rights. Countries such as Korea and Mexico, that were not members of the OECD at the time FCCC was agreed in 1992 but are now members of OECD, were considered as the main targets of this proposal.

Evolution is a concept the United States proposed in their draft protocol of January 1997. The gist is that, in the future, all countries automatically accept their own QELROs based upon agreed criteria. There will be several ways for introducing "evolution". For example there may be a phased-in introduction where countries, reaching preset figures such as GDP or per capita GDP, will assume a numerical emission obligation. Another way is that though all countries finally assume QELROs, their obligation depends on how Annex B countries observe their own obligations. Namely, to the extent developed countries become unable to comply their QELROs, developing countries duties will be watered down to voluntary ones.

Though the world shares the common understanding that the Annex B countries obligation in the first budget period is not enough to stabilize GHGs concentration, the central issue is that no one knows what the GHGs concentration we should aim for is. Unless we have reliable data on this, it will be rather hard to persuade developing countries to participate in the "Cap and Trade Scheme". In this respect, whether IPCC, in their third assessment report due in 2001, will be able to describe a greenhouse gas concentration level that would prevent dangerous anthropogenic interference with the climate system, is quite important.

But even if IPCC is unsuccessful in distinguishing a particular level of concentration, it is clear that we can not continue to emit GHGs as in the past. We have to cope with this situation bearing in mind the concept of "common but differentiated responsibilities". At the Berlin Mandate, it was set that the study never aimed to impose any new obligations on developing countries. But as the Mandate was aimed at the Kyoto meetings (COP3) and as COP3 finished with the imposition of the QELROs on developed countries, we should be free now to discuss the issue of developing countries' participation with developing countries. I should like to mention several practical points that will become crucial in future discussion.

First is how to set developing countries QELROs. It should not be set at a level that reduces

their emissions in comparison to their earlier levels. The target level should be one to reduce from, say, level of BAU (Business As Usual). But the point is how to estimate their BAU figures.

If the QELROs are set too high, developed countries' endeavors will be in vain, which developed countries will be unwilling to accept. This is one of the crucial points where the interests of Annex B countries and others conflict directly. Unless there exists a common perception of the GHGs concentration level for which we should aim for, it seems quite hard to find any criteria to set developing countries' BAU and targeted emissions. At this moment we are not sure whether IPCC will be able to show that level. However, if they can do it within a decade or so, it will be quite helpful, as detailed discussion of developing countries' participation will not be started until, at the earliest, the end of the first budget period.

Once developing countries' participation occurs, the price of tradable permits will be pushed down due to the increase of supply. This makes developed countries' (and private enterprises') earlier efforts not cost effective. How to deal these from an equity point of view? Or can Governments of developed countries persuade private sectors to accept that this will happen?

It is certain that developing countries will insist on additional money. Are developed countries ready for this?

Before developed countries ask other parts of the world to participate in a cap and trade scheme, can they comply with their commitment? Without this, it will be politically very hard to ask developing countries to join the scheme, unless some adverse effect to the global climate becomes visible.

There are many other points to consider (such as how and in what order should developing countries participate). What is important here is to start dialogue and discussion at the coming COPs and to form a common perception on climate change and its impact on the eco-system and human beings. For this purpose, it is academic society's role to provide the world various scenarios from a case of BAU to a case where all countries assume a certain obligation to reduce or limit their GHGs emissions. By doing so, I believe discussions based on scientific information will be activated.