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**13
TRADE & INVESTMENT UNDER THE
UNFCCC: THE OUTCOMES OF CANCUN,
AND THE ROAD TO DURBAN**

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TRADE & INVESTMENT UNDER THE UNFCCC: THE OUTCOMES OF CANCUN, AND THE ROAD TO DURBAN

Joshua Roberts¹

1. Introduction

The outcomes of climate change negotiations in Cancun in December were highly significant, not least because they restored confidence in the UNFCCC negotiating process. A number of COP decisions provide positive implications in the areas of international trade and investment. The Parties' commitment to a 2 degree Celsius increase in global temperature implied to investors that they are committed to tackling climate change. The Parties also signaled continued commitment towards the use of flexible mechanisms. Furthermore, progress on REDD +, and the newly established Technology Mechanism provides increased opportunities for developed and developing countries, along with private industries, to work together on investment, technology transfer and capacity-building for mitigation and adaptation to climate change.

However, a great deal of progress is still required. The Parties need to better articulate how they plan to deal with potential future conflicts of climate change policies with international trade and investment laws, and how they plan to address unilateral measures like border tax adjustments. Stronger signals are also needed to reassure investors about where the regime is heading, in terms of both targets and legal form. Lastly, unfinished products like REDD + the Technology Mechanism, and Carbon Capture and Storage (CCS) require more progress before the Durban negotiations.

This legal brief looks at the treatment of trade and investment under the International Climate Change Regime. It then analyzes the developments in the negotiations at COP-16/CMP-6 held in Cancun in November/December 2010, and looks at their effects on trade and investment. Overall, it concludes that the Parties have done a good job in restoring investor confidence in the climate change regime. However, a lot more needs to be done in the run-up to Durban in December, 2011.

2. Trade & Investment under the UNFCCC

Trade and investment are both covered in the UNFCCC and its Kyoto Protocol (KP). Under Article 3(4) of the UNFCCC, each Party, when considering which policies are appropriate for protecting the climate system,

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should “take into account that economic development is essential for adopting measures to address climate change.”² Article 3(5) also promotes a supportive and open international economic system leading to sustainable economic growth and development in all Parties, particularly developing country Parties. It states that measures to combat climate change, including unilateral ones, should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade.³ Furthermore, under Article 2(3) of the KP, Annex I Parties agree to “strive to implement policies and measures ... in such a way as to minimize adverse effects including, *inter alia*, the adverse effects of climate change and effects on international trade.”⁴

These provisions recognize the dual role that trade and investment can play in climate change. First, they can provide opportunities for sustainable economic growth, and increase cooperation between states, developed and developing; or, they can enhance the economic disparities between states, and result in disguised barriers to trade through measures such as border tax adjustments (BTAs). BTAs levy taxes on imports of carbon-intensive goods. They are intended to level the playing field between countries that regulate carbon emissions and those that do not. It is interesting to note that the wording of UNFCCC Article 3(5) seems neutral in that it does not endorse, but also does not prohibit the use of trade measures as a means of increasing the effectiveness of the Convention in terms of compliance and enforcement.⁵

At the Second Conference of the Parties to the UNFCCC (COP-2), Parties were urged to “improve an ‘enabling environment’ including the removal of barriers and the establishment of incentives, for private sector activities that advance the transfer of technologies to address climate change and its impacts.”⁶ This statement was repeated in future COPs,⁷ and inserted into Article 10(c) of the KP. The term was defined at Marrakech, and the Parties were also given implementation guidance.⁸

² Cordonier Segger and Gehring, “Trade and Investment Implications of Carbon Trading for Sustainable Development”; See also the United Nations Framework Convention on Climate Change (adopted 9 May 1992, entered into force 21 March 1994) 1771 UNTS 107 (UNFCCC), Art 3(4).

³ Yamin & Depledge, *The International Climate Change Regime: A Guide to Rules, Institutions and Procedures*, (Cambridge University Press, 2004), p 73.

⁴ Kyoto Protocol to the UNFCCC (adopted 10 December 1997, entered into force 16 February 2005) 37 ILM 22 (Kyoto Protocol), Art 2(3).

⁵ *Supra* n.3 at p 73.

⁶ Report of the Conference of the Parties on its Second Session, Held at Geneva from 8 to 19 July 1996 (FCCC/CP/1996/15/Add.1), Decision 7/CP.2.

⁷ Report of the Conference of the Parties on its Third Session, Held at Kyoto from 1 to 11 December 1997 (FCCC/CP/1997/7/Add.1), Decision 9/CP.3; See also Report of the Conference of the Parties on its Fourth Session, Held at Buenos Aires from 2 to 14 November 1998 (FCCC/CP/1998/16/Add.1), Decision 4/CP.4, and Report of the Conference of the Parties on its Fourth Session, Held at Bonn from 25 October to 5 November 1999 (FCCC/CP/1996/6/Add.1), Decision 11/CP.5, which emphasizes that an enabling environment for investment was important for promoting capacity-building activities in countries with economies in transition, decided that financial and technical support for capacity-building for these countries should be provided through bilateral and multilateral channels and the private sector.

⁸The Marrakech Accords defined “enabling environment” as focusing “on government actions, such as fair trade policies, removal of technical, legal and administrative barriers to technology transfer, sound economic policy, regulatory frameworks and transparency, all of which create an environment conducive to private and public sector technology transfer.” Report of the Conference of the Parties on its Seventh Session, Held at Marrakesh from 29 October to 10 November 2001 (FCCC/CP/2001/13/Add.1), Decision 4/CP.7.

In practice, an enabling environment was supposed to facilitate identification and removal of barriers to trade and investment through strengthening environmental regulatory frameworks, enhancing legal systems, ensuring fair trade policies, utilizing tax preferences, protecting intellectual property rights, and improving access to funded technologies and other programmes, in order to expand commercial and public technology transfer to developing countries.⁹ While progress has been achieved on some of these aims, the COP has done very little to elaborate on how to avoid trade conflicts through the use of unilateral climate change measures.

Both Annex I and non-Annex I Parties have been encouraged to cooperate in creating favorable conditions for investment in sectors where such investment could contribute to economy diversification.¹⁰ Flexible market-mechanisms such as the Clean Development Mechanism (CDM) Joint Implementation (JI), and ETS under Articles 12, 6 and 17 of the KP, respectively, were intended to help attain these objectives. These mechanisms have their legal basis in Articles 2 and 3 of the KP.¹¹ While providing a cost-effective approach to mitigation by developing countries, they are also intended to foster environmentally-sound investment, technology transfer and capacity-building between developed and developing countries.

This is particularly so for the CDM. One of the CDM's purposes is to assist Parties not included in Annex I in achieving sustainable development by incentivizing developed countries to invest in clean technology projects in developing countries.¹² The CDM was created with the KP.¹³ Its operating rules were agreed later in Marrakech, and were finalized several years later. These decisions established, *inter alia*, the CDM Executive Board (EB), and operational guidelines, modalities and procedures for the CDM.¹⁴ Further decisions in the coming years by the COP/MOP opened the way for new types of CDM projects related to small-scale forestry,¹⁵ elaborated rules governing forestry-related CDM projects—so-called Land Use, Land-Use Change and Forestry (LULUCF) projects,¹⁶ and strengthened the EB.¹⁷ The CDM's track record has not been perfect, and it has received criticism for a variety of reasons.

Joint Implementation (JI) and emissions trading under have both been used to promote international trade and investment between Annex I Parties. They are both meant to help Annex I Parties achieve their assigned

⁹ *Id.*

¹⁰ *Id.* at Decision 5/CP.7

¹¹ *Supra* n. 2.

¹² *Supra*, n.3 at Art 12(2).

¹³ UNFCCC COP-3 (FCCC/CP/1997/7/Add.1), Decision 1/CP.3.

¹⁴ Report of the Conference of the Parties on its Seventh Session, Held at Marrakech from 29 October to 9 November 2001(Marrakech Accords) (FCCC/CP/2001/13/Add.2), Decision 17/CP.7.

¹⁵ Report of the Conference of the Parties on its Tenth Session, Held at Buenos Aires from 2004 (FCCC/CP/2004/10/Add.2), Decision 14/CP.10.

¹⁶ Report of the Conference of the Parties on its Ninth Session, Held at Milan from 1 to 12 December 2003 (FCCC/CP/2003/6/Add.2), Decision 19/CP.9.

¹⁷ (FCCC/KP/CMP/2005/8/Add.1) Decision 3/CMP.1 on modalities and procedures for the CDM; Decision 7/CMP.1 on strengthening the CDM and improving its responsiveness, reviewing criteria for additionality and improving methodologies, and streamlining procedures for certain types of projects; and Decision 29/CMP.1 to provide assistance for capacity building.

emissions reduction targets while fostering climate-friendly technology transfer and diversification. JI was developed in a similar fashion to the CDM, although it was conceptualized earlier, and operationalized later,¹⁸ along with ETS at the first CMP to the KP.¹⁹ While JI has been used relatively little, the European Union has utilized the ETS in order to help achieve its reduction targets, and in 2010 the carbon market was said to be worth €121 billion (\$170 billion).²⁰

COP-13 in Bali marked another potential step forward for promoting investment in sustainable development and conservation, with an agreement to set up a work program on reducing emissions from deforestation and forest degradation (REDD).²¹ REDD projects are designed to incentivize investment in developing countries in exchange for preserving the integrity of their forests. Currently, only afforestation and reforestation projects are recognized under the CDM, but REDD+, as it is currently called, has been touted as a cost-effective mitigation technique that can also contribute to conservation and sustainable development. In fact, REDD was one of the few issue areas that saw significant progress in negotiations during Copenhagen.²²

3. Developments in Trade & Investment at COP-16/CMP-6 in Cancun

Cancun was significant for trade and investment for several reasons. First, the COP made positive progress on REDD + and the Technology Mechanism. Cancun also provided the investment community with some signals that the Parties are committed to continuing to address climate change and make use of flexible mechanisms to mitigate greenhouse gas emissions.

3.1. REDD+²³

The Agreement in Cancun on REDD + was successful in signaling that the international community is committed to providing positive incentives in combating climate change and promoting sustainable development. First, the decision provides important guidance for Parties, multilateral institutions and NGOs assisting in the pilot phase of REDD +, including REDD + readiness.

¹⁸ The Parties decided to establish a pilot phase for "Activities Implemented Jointly" among Annex I Parties at COP-1 in Berlin (FCCC/1995/7/Add.1), Decision 5/CP.1. However, JI did not become operationalized until CMP-1 in Montreal (FCCC/KP/CMP/2005/8/Add.2), Decision 10/CMP.1.

¹⁹ CMP-1 in Montreal (FCCC/KP/CMP/2005/8/Add.2), Decision 11/CMP.1.

²⁰ "Global carbon market worth €121 bn in 2010", *Commodities Now*, 29 January 2010. Accessed 3 February 2011. <<http://www.commodities-now.com/news/power-and-energy/1685-global-carbon-market-worth-121bn-in-2010.html>>.

²¹ Report of the Conference of the Parties on its Thirteenth Session, held in Bali from 3 to 15 December 2007 (FCCC/CP/2007/6/Add.1), Decision 2/CP.13 The Bali Action Plan gave the green light for the establishment of demonstration projects, and identified possible incentives as options to be further developed under the Ad-Hoc Working Group on long-term Cooperative Action under the Convention.

²² Copenhagen Accord (FCCC/CP/2009/11/Add.1), Decision 2/CP.15, paragraph 6.

²³ Draft decision -/CP.16. "Outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action under the Convention". The text can be accessed at the UNFCCC website: http://unfccc.int/meetings/cop_16/items/5571.php. REDD is addressed in Section III(C) and Annex I and II of the Draft Decision.

First, the decision gives guidance on how to implement REDD+ activities. Found in Annex I to the Decision, the Parties are given guidance on various policy goals that should be consistent with the design and implementation of REDD+ projects, and how to promote specific provisions of the Convention. It also lists specific safeguards that should promote and support relevant international conventions and agreements, respect for indigenous knowledge and their rights, participation of all relevant stakeholders and conservation of forests and biodiversity.²⁴

Also, the Decision gives guidance to countries on actions and information they should provide in order to receive adequate and predictable support to undertake REDD + projects. These are notably a national plan; a national reference emission level; a “robust and transparent” national forest monitoring system to monitor and report on REDD + activities; and a system for providing information on certain safeguards with regards to local community and indigenous peoples knowledge and rights. The decision also requests developed countries to coordinate finance and activities in each country with a REDD + project, and recognizes the roles that international organizations and other stakeholders can play in making REDD + function.

The Decision also asks Parties to address actions towards drivers of deforestation in national strategies or action plans. To this end, the COP also requests the Subsidiary Body for Scientific and Technological Advice (SBSTA) to identify land use, land-use change and forestry activities in developing countries, in particular those that are linked to drivers of deforestation and forest degradation.

3.2. The Technology Mechanism²⁵

The Technology Mechanism was originally included in the Copenhagen Accord. However, in Cancun it was further elaborated, and integrated it into the UNFCCC negotiations process. The Mechanism is designed to hasten development and transfer of climate-friendly technologies to developing countries in order to support mitigation and adaptation—something the CDM failed to achieve.

The Technology Mechanism has the potential to deliver on a lost commitment by developed countries to deliver effective climate-friendly technology transfer to developing countries to support mitigation and adaptation. Taking steps to operationalize the mechanism, the Parties established the Technology Executive Committee (TEC) to oversee it, to facilitate between governments and the private sector, and to recommend actions to address barriers to technology development and transfer. Furthermore, the Parties established the Climate Technology Centre and Network (CTCN) in order to “facilitate a Network of national, regional, sectoral and international technology networks, organizations and initiatives”.

²⁴ Draft decision -/CP.16, Annex I. The text can be accessed at the UNFCCC website: http://unfccc.int/meetings/cop_16/items/5571.php.

²⁵ *Id.* at Section IV(B).

The TEC and the CTCN should facilitate implementation of the Technology Mechanism under the guidance of the COP. The Technology Executive Committee is supposed to convene as soon as possible in order to elect its members and elaborate its modalities and procedures, which will be considered at the COP 17 in Durban. In order to make the Technology Mechanism fully operational before 2012, the Parties also requested the Ad Hoc Working Group on Long-term Cooperative Action under the Convention to look at issues such as governance structures, potential links between the Technology Mechanism and the financial mechanism, and additional functions for the TEC and the CTCN.

3.3 Flexibility Mechanisms

Concerns were expressed in Cancun on the need to signal continuation of the CDM and other flexible mechanisms amidst uncertainty over the future of the climate change regime after the KP ends in 2012. The Cancun Agreements do not contain any language in this regard. Nevertheless, it remains in the negotiating text.²⁶ Furthermore, the Parties indicated that emissions trading and the project-based flexibility mechanisms would continue to be available along with measures related to LULUCF. This signals at least an implicit commitment by the Parties to keep the flexibility mechanisms going in the event there is a gap period in legal regimes after the KP.

Furthermore, the COP agreed to allow carbon capture and storage (CCS) in geological formations to be an eligible project activity under the CDM, provided that issues over issues such as permanence are resolved.²⁷ The Parties also agreed to consider establishing one or more market-based mechanisms in Durban. This could possibly take the form of a sectoral crediting mechanism. These decisions represent increased investment opportunities, and guidance for future regulation. They signal the Parties' continued support for using flexible mechanisms in the climate change regime.

4. Implications of Cancun and the Road to Durban

Almost as significant as what was included in the Cancun Agreements is what was not included. While reaffirming that Parties should cooperate and avoid adopting unilateral trade or protectionism measures on the grounds of climate change, the parties could not reach any substantive agreement on the issue. Therefore, it was left to be dealt with in latter negotiations. However, the COP must address issues like border tax adjustments and embedded carbon in the trade of international goods. If states don't find guidance from the UNFCCC on what is fair and acceptable in terms of domestic climate change regulation, they will find it through increasing trade disputes and litigation.

²⁶ Language regarding continuation of the CDM is contained in Chapter III of document FCCC/KP/AWG/2010/CRP.4/Rev.4. Decision -/CMP.6 Outcome of the work of the Ad Hoc Group on Further Commitments for Annex I Parties under the Kyoto Protocol at its fifteenth session. See the advanced version of the decision at http://unfccc.int/meetings/cop_16/items/5571.php.

²⁷ Decision -/CMP.6 Carbon dioxide capture and storage in geological formations as clean development mechanism project activities.

Moreover, it was good that the Parties were able to signal their commitment to hold the increase in global average temperature below 2 degrees Celsius. However, what the investment community is really waiting for is targets. When Parties finally commit to firm targets, the investment community will be able to plan and make decisions to allocate more funds towards climate-friendly goods and services.

The COP also needs to signal to businesses what legal form the international climate change regime is heading. This should take the form of a binding and strong agreement by the Parties. The CDM and ETS will not go away simply because Kyoto ends. However, there is no telling how successful these mechanisms will be without assured legal guidance from the COP. Time is running out on the KP, and the weaker the decision on the regime's future, the less robust the response will be from the investment community. The issue of legal form will certainly need to be addressed and hashed out in Durban.

There is also much to be done in terms of progress on unfinished mandates. First, countries with REDD + projects must begin to implement the framework that has been agreed upon, and the SBSTA still has a lot of methodological work to complete. More importantly, REDD + must show its worth, not just in terms of how much investment it can generate in developing countries, but in how effectively it can save forests, conserve biodiversity, assist with sustainable development, and respect indigenous peoples' and local communities' rights. There is growing skepticism as to whether REDD + can actually achieve these objectives, and there is suspicion that REDD + may even create perverse incentives that will drive further deforestation. Strong safeguards must remain in the text in order to achieve balanced results.

Second, while the TEC and the CTCN have been established to manage the Technology Mechanism, details on modalities still need to be agreed upon by the Parties. There is also the task of gaining participation from a broad range of stakeholders, particularly those in the private sector. Skeptics of international arrangements for technology diffusion may need convincing, and it is up to the Parties to show them that the Technology Mechanism is of a new breed. Lastly, several issues need to be dealt with before new flexible mechanisms such as CCS can become operational.

5. Conclusion

The climate change negotiations are definitely back on track. Steady movement forward on issues related to international trade and investment were certainly achieved in Cancun. For this, the COP deserves credit. Nevertheless, there is still a lot of groundwork to lay in the run up to Durban. The investment community is looking for guidance on next steps to take in terms of providing funding for climate-friendly goods and services. More initiative by the Parties to the UNFCCC in 2011 will go a long way towards facilitating a greener economy and sustainable development.

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