



International Chamber of Commerce

The world business organization

Department of Policy and Business Practices

Monitoring, Compliance, Enforcement and Liability under the Kyoto Protocol

An Update of ICC's views for the UNFCCC COP 11, COP / MOP 1 November 28 – December 9, Montreal

The International Chamber of Commerce (ICC) represents a broad constituency across global business with members in 140 countries representing over 7500 small, medium and multinational companies. Because these companies operate in a wide range of business sectors and regions, they naturally have varying perspectives on the actions and strategies best suited to combat climate change. This paper was prepared by the ICC's Climate Change Task Force, which comprises interested representatives of all major business sectors; it reflects the consensus views of ICC members. As a non-governmental organization participating at meetings of the United Nations Framework Convention on Climate Change, ICC acts as an observer on behalf of its members and seeks to ensure that the views and expertise of business and industry are available to negotiators.

Introduction

In a globalizing world characterized by more open trade and investment, the links between international treaty obligations, domestic regulations, and national implementation strategies assumes a growing importance for all companies. This is true both for multinational companies (MNCs) and for small and medium enterprises (SMEs). While compliance and enforcement measures and their potential impacts on competitiveness, trade and investment affect all business, it is important to note that costly and complicated procedures may raise special difficulties for SMEs.

This paper will discuss a range of business issues and perspectives relating to the Kyoto Protocol's compliance and enforcement measures, to, inter alia:

- Complement the ICC Position Papers on Kyoto Mechanisms and Long-term Approaches to address climate change;
- Suggest options to encourage consistent compliance with climate policy within the free market;
- Raise issues relating to the business impacts of enforcement and compliance measures to be developed as part of the Kyoto Protocol;
- Discuss the interface between domestic and international climate compliance and enforcement issues for business;

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- Highlight potential climate-related trade and investment issues that should be taken into account in light of the WTO Millennium Round.

The design, implementation and enforcement of compliance regimes both for national compliance with Kyoto obligations and for firms' compliance with domestic obligations will be of critical concern to business and industry. This is particularly true in the connection with emissions allowances recognized under the Kyoto Protocol because they serve a dual role. On the one hand, they are instruments that are required for nations to comply with their international obligations under the Kyoto Protocol. On the other hand, they are also instruments usable by firms to comply with their obligations under domestic implementation. Consequently, there is an inherent link between domestic procedures for nations to insure that firms comply with national obligations and international procedures to assure that nations meet their obligations under the Kyoto Protocol. The integrity of compliance and enforcement will influence the credibility, utility and market price of GHG allowance trading.

Considerations of compliance, enforcement, and sanctions for non-compliance under the Kyoto Protocol and Kyoto Mechanisms involve three distinct, but interacting levels:

- The first concerns governments and their international obligations.
- The second involves business domestic obligations and actions as part of national implementation strategies.
- The third includes specific transactions, such as those involved in creating credits through emissions reductions in projects or in trading emissions allowances.

The Kyoto Protocol binds governments to their respective commitments. Sanctions for failure to meet Protocol commitments would apply to governments. How a particular business will be affected depends both on the domestic implementation strategy of those countries where that firm operates or does business and also on the consequences to nations that fail to comply with their obligations. Business is particularly concerned with the implications for firms if nations are prohibited from participating in Kyoto Mechanisms.

Multinational companies will be affected by the varying commitments and implementation measures in each country where they operate. Local companies and SMEs will face similar challenges which could be encountered directly, as well as in connection with smaller companies' business relationships with larger firms (joint ventures, supplier/contractor, etc.).

Finally, the validity of individual transactions between entities involved in projects and trades could be subject to obligations ranging from international and domestic procedures, to contractual terms binding government and non-government participants in the creation or exchange of credits.

For a business enterprise of any size, compliance with domestic emissions obligations and national implementation strategies will involve a series of distinct issues, in each one of the countries where it operates:

- What emissions are covered?
- Which business activities and/or products are covered?



- How are these emissions measured?
- How are emissions reported?
- How are decisions about compliance/non-compliance rendered?
- What procedures, including appeals procedures, apply to situations of non-compliance and possible sanctions?
- How does the domestic system link to international mechanisms?
- How are costs associated with compliance recovered by companies?

Business recognizes that answers to these questions may differ in each Annex I country depending on its particular implementation strategy. Differences by countries in handling of these issues may also have implications for individual companies' business strategies.

Compliance and Monitoring

A. Encouraging Compliance

One of the principles of the United Nations Framework Convention on Climate Change (UNFCCC) is that measures to deal with climate change should be cost-effective to ensure global benefits at the lowest possible cost. This has clear significance for encouraging compliance. The extent to which the Kyoto Protocol develops truly "flexible" and transparent frameworks and institutions with low transaction costs is a fundamental concern for business and industry and will be critical in ensuring cost-effective responses to the climate challenge.

Excessive rules, regulations and costs should be avoided and potential barriers to industry participation should be eliminated from the outset. A range of policy options, including voluntary initiatives and negotiated long-term voluntary agreements, changes in capital depreciation schedules and tax incentives for research and development, and reform of regulatory barriers to commercialisation of innovative technology, among others, can also, if correctly designed and with proper enabling conditions in place, play an important role in reducing emissions cost-effectively. Such cost-effective options can in turn encourage compliance with lower transaction costs.

The imposition of ceilings or other limits on the use of Kyoto Mechanisms would add other burdens of uncertainty concerning business use and compliance. Consider the case of a country near its ceiling and two companies, each with significant Clean Development Mechanism (CDM) projects nearing final approval. A ceiling based on complementarity or some other limit might only allow one project to be accepted. Both may have involved substantial, long-term business effort and expense to plan and develop the project proposals. Once one project has been approved, the next could not be allowed. This situation could create substantial disincentives to firms undertaking the advance effort required to develop a project in the first place. It would also create the potential for arbitrary or corrupt decision-making processes in governments and international authorities involved in the CDM process.

Similar situations could apply to emissions trading. A country near its complementarity ceiling might find itself open or closed to trades as each new transaction alters its balance. Again this



produces conditions under which markets would be highly constrained and potentially subject to manipulation.

B. Monitoring & Reporting

Credible compliance and enforcement requires credible and consistent monitoring and reporting. The Convention has already instituted procedures for nations to report their emissions, although questions remain about the accuracy, timeliness and completeness of those reports. These will become particularly pressing if lingering concerns call into question the integrity of national reports under the legally binding Kyoto Protocol. Timely and fair resolution of outstanding issues or those that may arise is essential for decisions regarding the design of compliance and enforcement measures.

In each national setting, firms may be subject to varying obligations and procedures for measuring emissions, reporting and monitoring. To the extent possible, care should be taken in designing requirements for companies to avoid imposing unnecessarily onerous and costly monitoring and reporting procedures, while ensuring accurate, meaningful, credible and comparable data. Because allowance trading can occur across borders, it is important that procedures, reliability and costs should be comparable. Otherwise, competitive distortions will arise.

The implications for companies of multiple, differing monitoring and reporting requirements and procedures should be carefully considered. Wherever possible, voluntary approaches to monitoring and self-monitoring should be permitted. Principles of flexibility and efficiency and an appropriate balance between the cost of monitoring and enforcement should be incorporated into monitoring frameworks and will be of critical importance from a business perspective.

Enforcement and Non-Compliance

Domestic enforcement should be non-discriminatory and consistent across sectors, between domestic and foreign companies, and between SMEs and MNCs. Voluntary agreement reporting and enforcement should be consistent with those procedures required in other domestic implementation programs.

While recognizing that initially these remarks pertain to Annex-1 countries, industry believes that non-Annex 1 countries should not lower their standards of enforcement of domestic programs in order to attract foreign direct investment.

A. Non-Compliance and Companies

A key issue for business is how non-compliance by nations will affect companies of all sizes across each of the countries in which they operate. How will Protocol enforcement measures treat companies that are in compliance with domestic rules in a country that is itself out of compliance with its international obligations? Business cannot support proposals suggesting that such companies' transactions under Kyoto Mechanism transactions might be revoked or reversed, in effect depriving companies of their property rights in instances where they have acted in good faith. By the same token, lack of compliance and broader "rule of law"



considerations in any participating countries will certainly impact competitiveness, and should be addressed in designing compliance and enforcement measures.

B. Buyer and Seller Liability

If appropriate contractual and legal frameworks are in place and are enforced, markets will be able to incorporate risks that can then be built into costs. However, if national or international constraints are placed on the use of Kyoto mechanisms that distort the operation of the market, this will negatively impact the appropriate assignment of liability. While commercial contracts can and will account for such distortions, they will inevitably raise transaction costs.

In situations without appropriate contractual and legal frameworks, the multiple layers of approval that could be required to authorize project proposals may lead to arbitrary or corrupt practices. Such practices would jeopardize the integrity of the entire linked system of Kyoto Mechanisms.

The Way Forward: Issues

The Kyoto Protocol's enforcement and compliance measures should be developed within the existing World Trade Organization (WTO) disciplines, observing most-favoured nation (MFN), like-product rules and sound science criteria and avoiding discrimination based on methods of processing and production (PPMs).

Enforcement and compliance under the Kyoto Protocol should not compromise a country's WTO rights. Business is concerned that some forms of domestic implementation which seek to offset "carbon leakage" could lead to the establishment of trade barriers in the form of tariffs, border taxes, discrimination and labelling.

Conclusions

Business believes that working within frameworks that liberalize trade, commerce and investment and that recognize and work in harmony with market forces will facilitate compliance and lessen transaction costs for enforcement of Kyoto commitments. Working at odds with these framework conditions will add additional and unnecessary costs and obstacles to the already challenging task of addressing climate risks for those nations seeking to implement ambitious Kyoto commitments. Because officially recognized emissions allowances become a kind of universal currency for compliance both by nations and by firms, the integrity and design of compliance systems require careful consideration. Clear and transparent regulatory frameworks with certain, uniform, non-discriminatory enforcement and the avoidance of trade and investment barriers will contribute to a less costly, more efficient and credible system.

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