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Trade Implications of Climate Policy after the Paris Outcome

CONTRIBUTION

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Introduction

At Paris in December 2015, 188 countries adopted a landmark climate change agreement at the 21st Conference of the Parties (COP21) of the United Nations Framework Convention on Climate Change (UNFCCC). The Paris Agreement is ambitious in its scope, aiming to limit climate change to as little as 1.5°C global mean temperature change, targeting a ‘balance’ of atmospheric greenhouse gases (GHGs) by the second half of the century, and expecting progressively more ambitious mitigation commitments from all states party to the treaty over the coming decades. It is also novel in its approach: all member states will be legally bound to make commitments, but each state will determine the nature of its commitment and is not legally bound to deliver the policies that they comprise. The agreement’s novelty has led some critics to question whether it will deliver against its ambition.

On the other hand, it has already gained remarkable momentum: 161 countries provided voluntary pledges in the form of Intended Nationally Determined Contributions (INDCs)1 and 175 countries signed the Paris Agreement at its opening to signature on 22 April 20162. These INDCs are estimated to limit climate change to between 2.7 and 3.7°C if fulfilled3. While clearly insufficient to avoid catastrophic climate impacts, the high level of INDC participation provides a degree of hope that states will participate robustly in the subsequent mandatory regime.

Regardless of whether the Paris Agreement achieves its full ambition or not, it will very likely result in progressively more stringent climate policy in most of the world’s economies. These policies will both affect trade directly and interact with the legal regime governing trade. This issue of Commonwealth Trade Hot Topics reviews the outcome of COP21, analyses some of its possible impacts on trade, and then considers the implications specifically for small island developing states (SIDS), a group vulnerable to changes to climate and trade.

The legally binding goals on limiting temperature change and reducing emissions agreed in Paris will
require changing domestic environmental and climate policies, strengthening international emissions trading regimes and facilitating greater transfer of low carbon technology, all of which have international trade dimensions. National and global action on climate change may also impact on the nature of international trade itself, particularly of high-carbon traded goods (i.e. fossil fuels). While each topic covered could merit much deeper analysis on its own, this paper takes a broad overview of these implications of Paris on trade.

Debriefing on COP21 and the Paris Outcome

Pledges and positions in the lead-up to Paris

In the lead-up to COP21, negotiating blocs largely reflected the same alignment of perceived interests that has dominated talks since at least COP15 in Copenhagen. A crude picture can be drawn. The European Union and the USA, industrialised historic GHG emitters with emissions caps under the Kyoto Protocol, sought to broaden the agreement to require all states to make mitigation commitments. The large emerging economies, like India, China and Brazil, aligned themselves with smaller and less developed economies to emphasise the need for aggressive emission cuts from the industrialised economies, and to seek new and additional financial assistance, ‘climate finance’, as a condition to action for all developing economies.

SIDS pushed for even greater ambition than the 2°C target that has been contemplated since COP15, to avoid catastrophic impacts likely to affect them even in a 2°C-rise world, and pushed for compensation for loss and damage from impacts to which they will be unable to adapt. Developing countries, particularly the SIDS and African states, also emphasized the need for greater allocations of climate finance for adaptation. Many experts, and negotiators, were understandably sceptical as to what successor agreement to the Kyoto Protocol could be achieved in light of misaligned positions of the various blocs, and particularly between historic and new major emitters.

During the conference, a new group emerged, the so-called ‘High Ambition Coalition’ of more than 100 states, which dramatically changed the terms of the negotiations. This coalition had been formed among primarily the African bloc, the SIDS, the USA and EU, largely in secret, over the prior six months. During the conference it was able to add other influential member states, including Brazil, Canada and Australia, to its ranks. The coalition adopted the universal mitigation approach of the USA and the EU, with the much more aggressive targets sought by the SIDS and African states most affected by climate change. It focused on establishing a COP agreement with legally binding, science based long-term goals and a system by which to track and review progress on a five-year cycle. By aligning developing and developed world interests, it largely succeeded in its ambitions for Paris.

The Paris Outcome legal framework post-Kyoto

The ‘Paris Outcome’ comprises the decisions of the parties to COP21, including adopted text of the Paris Agreement, the successor treaty to the Kyoto Protocol. It establishes several new long-term goals. These provide not only some principled stance around which efforts will coalesce, but also represent a measure against which individual and collective pledges can and will be evaluated. With respect to mitigation, the Paris Agreement states two long-term temperature goals underpinned by two emissions-related goals. It also has an adaptation goal.

The agreement sets as a target an overall temperature limit of ‘well below 2°C’ global mean temperature change relative to pre-industrial levels, and ‘efforts’ to limit such change to 1.5°C. The 1.5°C target was a critical negotiating issue for the SIDS, as many of the climate impacts anticipated even at a 2°C global mean temperature rise are very likely to result in catastrophic damage to these states. The agreement also sets as an objective the peaking of global greenhouse gas emissions ‘as soon as possible’, and the achievement of a ‘balance’ between emissions and sinks between 2050 and 2100.

While the requirement of 1.5°C to 2°C ‘balance’ is likely to be the subject of continued discussion in coming years, it is worth considering briefly the implications of these long-term objectives in the context of climate science. Any temperature limit will require a ‘zero net’ balance of sources and

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sinks. Given the absence of any viable, practical technological means of creating a GHG sink in the near term, all scenarios for temperature stabilisation at even 2°C will require deep decarbonisation from current levels by present-day large emitters, and a rapid peak and decline by countries with low levels of emissions.

The deal establishes a ‘global goal’ on adaptation of ‘enhancing adaptive capacity, strengthening resilience and reducing vulnerability to climate change’ and makes provisions for inclusion of adaptation objectives in the pledging process outlined below.

A transparent, accountable pledge and review mechanism

The central mechanism of the Paris Agreement is a ‘pledge-and-review’ process. Every five years the parties will submit increasingly ambitious nationally determined contributions (NDCs) that lay out mitigation plans, and may include ones related to adaptation. All parties are left to establish their own national policy framework to achieve the commitments outlined in such NDCs. Countries are also required to report emissions, with progress reviewed by a ‘facilitative, non-intrusive, non-punitive’ independent review system against common metrics still to be defined, with flexibility given to developing countries in light of their weaker capacity to collect and report data.

COP member states generally acknowledged that existing voluntary INDCs, delivered as part of the COP21 process, are collectively of insufficient ambition to meet the Paris Agreement’s objectives. They have therefore agreed to convene a 2018 facilitative dialogue to inform the next round of commitments. The Paris Agreement stated that parties will, by 2020, either confirm or update their INDCs as NDCs under the Paris Agreement, and will include 2030 targets. The first stocktake of progress will occur in 2023.

Climate-related aid and compensation

The Paris Agreement requires developed countries to continue to assist developing countries financially in their efforts to mitigate and adapt to climate change, and the agreement encourages other countries to contribute voluntarily. The more flexible decisions of the Paris Outcome include an agreement to establish prior to 2025 a ‘new collective quantified’ climate finance goal of no less than US$100 billion per year.

The Paris Agreement also includes an article on loss and damage (Article 8), defining the scope of the concept but falling short of establishing any express basis for liability or compensation for it.

Implications for trade-led development

The legally binding goals on limiting temperature change and reducing emissions agreed in Paris will require changing domestic environmental and climate policies, strengthening international emissions trading regimes and facilitating greater transfer of low carbon technology, all of which have international trade dimensions. What trade issues do these raise?

Carbon trading

A central feature of the Kyoto Protocol was the establishment of a global emissions trading scheme, with the aim of using market-based trade to promote economically efficient mitigation. The Kyoto Protocol established a Joint Implementation (JI) regime for trade among states that had emissions caps, and a Clean Development Mechanism (CDM) to allow states with emissions caps to offset these by purchasing emissions reductions from non-capped states. JI and CDM led to a large volume of Europe-dominated and project-based emissions trading, with the CDM credit supply largely captured by China, to the exclusion of least developed countries (LDCs) unable to compete with China’s efficient, low-cost project pipeline.

The central feature of the Paris Agreement is the ‘pledge and review’ process outlined above, in which all states are obligated to set domestic mitigation targets and the system relies on domestic policies to achieve those targets. Such domestic policies may include national or sub-national emissions trading programmes.

To complement such national policies, Article 6 of the Paris Agreement provides two mechanisms for international emissions trading regimes:

1. ‘recognising’ as qualifying for emissions reductions international trade among domestic emissions trading schemes; and

2. providing scope for a voluntary centralised UNFCCC-managed mechanism for a transfer of emissions reductions between the different signatories to the Paris Agreement called the ‘Internationally Transferred Mitigation Outcomes’ (ITMOs).
The first of these two mechanisms builds on the core NDC mechanism of the Paris Agreement. Some States party to the agreement may meet domestic NDC targets through establishment of emissions trading regimes. As of 2015, 35 countries and 22 cities, states and regions have established some form of emissions trading scheme. The Paris Agreement will recognize traded credits when such domestic emissions trading programmes link and arbitrage credits between themselves. Trading member states will be able to determine domestically what constitutes an emissions credit, but trade in such credits between member states will have to meet UNFCCC established guidelines. Shared standards will ensure that credits with different emissions values can be harmonised, and help to prevent double-counting between a state producing emissions reductions and one acquiring them.

The second of these two mechanisms, informally being called the ‘sustainable development mechanism’ (SDM), will likely draw heavily from the CDM and JI elements of the Kyoto Protocol. It is, however, already notably different from CDM in a few important respects. First, whereas CDM emphasized trade in emission credits from project-based activities, the reference to ‘outcomes’ in ‘ITMO’ suggests that the SDM will have encompass a broader range of activities. Second, Article 6 expressly provides that the SDM will be used to ‘promote sustainable development’ alongside mitigation, suggesting a balancing of objectives between exchange in least-cost emissions reductions wherever they may be, and ensuring participation by and benefits to poorer and more vulnerable countries that may otherwise have weaker capacity to participate in the scheme. Revenue generated from the platform will go both to maintaining the platform and benefiting LDCs in particular. Some commentators have suggested that CDM credits may not be recognised under the new regime, and expressed concern as to whether there will be sufficient demand for ITMOs. More details of the framework are expected to be established by COP22 in Marrakesh in November 2016.

**Technology transfer**

Technology transfer is a crucial element of trade-related development under the new international climate regime. As low-carbon technology proves economically competitive with historic higher carbon development pathways, the ambition of states will shift more heavily from new and additional financial resources and towards access to innovations and the institutional capacity to support those innovations. Developing countries, led by India, advocated for strong technology transfer provisions, and in particular the increased availability of free intellectual property for the purpose of faster diffusion of clean technologies.

Section G of the Paris Agreement creates scope for the further development of a regime for technology transfer. It establishes as norms the ‘strengthening of co-operative action’ and ‘promoting and enhancing access’, and builds on the ‘Technology Mechanism’ already established under the Kyoto Protocol in 2010. It regrettably, however, provides little detail as to how these norms must, should or will be pursued in practice. On the other hand, some argue that trade itself may foster technology transfer as a co-benefit, and thereby be at least a partial means to this Paris Agreement objective.

**Climate policy and international law governing trade**

Fulfilling the Paris Agreement will require substantial new domestic environmental policies in each state party to the treaty. These may take many forms – pollution controls that also result in GHG mitigation, land use regulations, clean infrastructure investment targets, or policies aimed at fostering of innovations or new industries. International trade law may in some cases be perceived to conflict with the measures taken by states to implement the Paris Agreement. For a detailed treatment of the international trade regime as it relates to climate change policies, see: Low, P., Marceau, G., Reinaud, J. (2011). "The Interface between the Trade and Climate Regimes: Scoping the Issues” WTO Staff Working Paper ERSD-2011-1 - https://www.wto.org/english/res_e/reser_e/ersd201101_e.pdf

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are at least three broad issues at the heart of this potential conflict.

First, a major change to domestic environmental law and policy may be regarded by foreign investors as constituting an ‘indirect expropriation’ of their investment. Where a bilateral investment treaty (BIT) or multilateral treaties – such as the World Trade Organization (WTO) trade rules or the North American Free Trade Agreement (NAFTA) – protect foreign investors from expropriations, they may seek claims in response to climate-related law and policy. Although this has not yet happened with respect to domestic climate laws, it has occurred with respect to other environmental laws\(^9\) despite the exemptions for environmental policy in most trade agreements, including the General Agreement on Tariffs and Trade of 1994 (GATT) Article XX\(^{11}\). There is a robust body of literature critiquing the international trade law system for its potential to constrain domestic environmental regulation.\(^{12}\)

Second, WTO rules may prevent states from regulating traded goods on the basis of the climate impacts of their production. WTO rules, under Article III of the GATT and related agreements, require regulating ‘like’ products alike, whether imported or domestically produced. These rules limit the ability of states to impose regulations of an internationally traded good on the basis of the process and production method (PPM) used to manufacture such good. As with the prior issue, much ink has been spilled over the implications of these trade rules for the ability of states to implement environmental laws.\(^{13}\) A number of WTO disputes have historically challenged the ability of countries to implement environmental laws that differentiate products on the basis of the environmental impacts of their production methods, although some argue that dispute settlement bodies have become increasingly tolerant of environmental policy.

This issue could become live again in the context of climate policy. For example, an energy intensive manufactured good may be associated with a large amount of GHG emissions if coal is used to produce it, but the product may otherwise be identical to a low-carbon produced domestic version of the good, and thus ‘alike’ for the purpose of trade law.\(^{14}\) Electricity itself is also a traded good under GATT rules, complicating the ability of states to limit power trading on the basis of whether electricity is generated by fossil fuels or renewables.\(^{15}\)

Finally, states may seek to protect low-carbon industries as a means of achieving long-term decarbonisation targets, and these trade protections may run contrary to free trade principles. This issue has already seen a challenge directly bearing on a country’s ability to implement their NDCs. The USA recently won claims filed against India in 2013 and 2014 for India’s inclusion of domestic content requirements in its National Solar Mission.\(^{16}\) The USA contended that this was an unfair barrier to American-manufactured solar components, while India contended it a necessary

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element of domestic climate policy.\textsuperscript{17} While trade experts will often regard local sourcing laws as purely protectionist, the ability of states to incubate new domestic industries, or even strike political bargains, may be important to supporting low-carbon sectors and thus mitigation.

Climate policy will also have impacts on trade directly. While it is difficult to consider the entirety of these effects, it is possible to identify some broad patterns. The most obvious implication is on global fossil fuel markets.

Seaborne coal markets are already in decline, largely because of competition with cleaner energy sources. The two greatest consumers of seaborne coal over the last two decades – China and India – have seen declines in demand in the last two years, and financial institutions such as Citigroup believe that market forces, combined with the added factor of climate policy, put the sector in terminal decline.\textsuperscript{18} Major banking institutions like JP Morgan Chase are now no longer financing greenfield coal mining or generation projects in OECD countries.

The recent oil price crash had dramatic implications for oil exporting and importing countries. While the crash itself was largely attributable to the US shale oil boom and the response of the Organization of the Petroleum Exporting Countries (OPEC), it gives us some insight as how increasingly stringent climate policies, and changing technologies, might affect global trade in the commodity. Demand imbalances have proved a near-term benefit for oil importing countries, including in the developing world, while harming oil-exporting economies.\textsuperscript{19}

An increasingly stringent climate policy environment will certainly result in oil demand reductions first in industrialised economies and then globally. Substitution of oil in the transport sector with gas, biomass or electricity, will also reduce demand across the globe as alternative fuel markets emerge. Undiversified oil exporters will be impacted adversely. OPEC discipline is like to be strained. Oil-importing nations may reap the short-term benefit of lower prices from trade imbalances brought on by decreasing demand from industrialised countries, but will eventually face a new equilibrium as production constricts.

Implications of the Climate–Trade relationship for SIDS

Climate change and trade are both critical issues for SIDS: they are the countries most vulnerable to climate change, and are highly dependent on trade. Fulfilment of the Paris Agreement’s most ambitious targets is critical to the economic and social well-being of these states. Historically, the international trade regime has often failed to fully take into account the interests of SIDS. Because delivering on Paris is so crucial for the survival of these economies, SIDS may play a critical role diplomatically in ensuring that trade rules align with the ability of states to implement domestic environmental policy agendas, often a process poorly understood by the trade policy community. Because they are at the forefront of climate risk, SIDS may be in a special position to ensure that trade law does not present an undue barrier to robust climate policy, and that likewise climate policy does not exacerbate the SIDS trade vulnerabilities.

Climate policy itself will have varied effects on these states. Most SIDS are highly dependent on fossil fuel imports, and near-term global trade imbalances that arise with declining global demand for these resources should be seen as a

\textsuperscript{17} Lilliston, B. (February 25, 2016). “Obama undermines climate efforts in solar trade dispute”\textsuperscript{17} IATP - http://www.iatp.org/blog/201602/obama-undermines-climate-efforts-in-solar-trade-dispute;


political window of opportunity to get their fiscal house in order, opening policy opportunities not available in other economic climates. Low oil prices, for example, improve balance of payments, which improve the fiscal capacity of these countries to invest in things like greener infrastructure. Likewise, low oil prices can open political opportunities for fossil fuel subsidy reform. For economies highly reliant on fossil fuel exports, if declines in fossil fuel prices from climate policy and a low-carbon transition are likely to result in a new (and lower) equilibrium price point, this creates a formidable crisis requiring urgent economic diversification.

The SDM and technology transfer provisions of the Paris Agreement also provide some glimmer that new trade opportunities will emerge specifically out of the climate policy regime that could be relevant for SIDS. The SDM promises to represent a framework more expressly targeted at ensuring participation by, or at least benefits for, developing countries. However, recalling that this is not at present the main avenue for mitigation under the Paris Agreement, it remains to be seen whether demand for developing country emissions reductions will be a major source of exchange and opportunity or only play a minor role. It is also unclear whether the scope of the SDM will specifically favour LDCs or a broader group of developing or vulnerable states that reflects the specific circumstances of the SIDS – an issue that arose under the CDM of the Kyoto Protocol20.

The agreement also articulates the need for technology transfer, which in principle could be of value to developing SIDS. Again, however, the vague nature of the Paris Agreement’s provisions on technology transfer commends some caution as to how and when this element of the agreement will actually affect the global economy.

Conclusions

The historic events at Paris represent a major turning point in the global community’s engagement with the threat of climate change. It takes a bottom-up approach that relies on the actions of individual countries to rein in their respective emissions and climate risks, while also acknowledging the different circumstances and needs of developing countries.

The bottom-up approach of the Paris Agreement is less explicitly reliant than the Kyoto Protocol on international GHG emissions trading as the mechanism for global mitigation. Even so, it does leave open the possibility that international trade in GHG emissions allowances will play a material role in the future.

This bottom-up approach also leaves each state to develop its own climate policies, which creates the risk that the trade community will see national climate policies in the spirit of the Paris Agreement as imposing unilateral trade barriers. While most of these potential conflicts are surmountable with a sophisticated understanding of environmental law and policy, the trade community has a contentious record on this historically. States with both an interest in seeing robust climate action and a deep involvement in trade negotiations are in an important position to ensure harmony between these two regimes.

Finally, climate policy will begin to shape the contours of international trade, particularly for fossil fuels. Recent events in these markets – such as the oil price collapse and structural decline in coal markets – were not caused by climate change policy, but they give us some indication of the potential risks that more stringent climate policy poses to the sector. Importers and exporters will, for different reasons, need to manage carefully the implications of the eventual structural decline of these sectors for their own economies.

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