

## **Open Trade with the US without Compromising Canada's Ability to Comply with its Kyoto Target**

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The US and Canada are two important partners of the North American Free Trade Agreement (NAFTA). Canada, together with most industrialized countries, has ratified the Kyoto Protocol and begins implementing domestic policy measures aimed at meeting its legally binding Kyoto emissions target of six percent below 1990 levels. In the meantime, the US has made it clear that it will pursue a separate climate strategy as outlined by the Bush Climate Change Initiative, and thus that it will at least initially not be part of the international regime. Given that no other two countries in the world trade as much between themselves as do Canada and the US, Canadian industries have much greater competitiveness (trade) concerns brought about by the different playing fields where Canadian industries face mandatory emissions constraints but US industry emissions are uncapped. All this puts Canada in a very difficult position to meet its Kyoto target, in comparison with Japan and the European Union (EU). Thus, the relationship between the US and Canada is of much higher policy relevance than, say, focus on the US and Japan/the EU. Against this background, this paper aims to address the following six major policy issues.

First, Canadian energy exports to the US are bound to increase under the new US energy security policy. Consequently, this will greatly increase emissions in Canada, and further increase Canada's difficulty in meeting its Kyoto target. One way to deal with increased emissions in Canada as a result of increasing energy exports to the US is to incorporate the abatement costs associated with the production of energy exported in energy pricing. Another way is to increase the amount of cleaner energy exports to the US. Canada has argued that these clean energy exports reduce US and global emissions and thus is entitled to receive credits for the resulting emissions reductions. However, the political and legal uncertainties and technical complexities associated with Canada's proposal have cast the doubt on the likelihood of this as a realistic solution.

Second, located in the territory of Canada, Canadian subsidiaries of US multinationals are obligated to follow the same rules as any other domestic entities and foreign-owned entities in Canada. In the meantime, these subsidiaries are entitled to emissions permits to operate in Canada. No matter which method is used to initially allocate Canada's assigned amount, they should not be treated less favorably than similar domestic entities. Any differential treatments on the basis of ownership in the initial allocation of permits will violate the WTO principle of non-discrimination.

Third, if the US adopts domestic mandatory emissions limits and decides to recognize Kyoto permits for purpose of compliance with its domestic requirements, should the Kyoto Parties like Canada be allowed to transfer their permits to non-Kyoto Parties like the US? This is very important not only because it virtually makes US-based firms bear mitigation costs but also because it is essential for intra-firm emissions trading within a multinational corporation, as experienced by British Petroleum and Shell. This would also increase overall demand for Kyoto permits and push up the price of permits, thus increasing incentives to invest in clean development projects in developing countries. However, recognizing credits from emissions reduction projects in non-Kyoto Parties like the US would require an amendment to the Protocol. Canada and other major negotiating Parties have no interest at all in amending the Protocol to recognize those credits and allow them to enter the Kyoto market. Nevertheless it is possible to trade between Kyoto permits and non-Kyoto credits via a clearinghouse system.

Fourth, significant sinks credits allowed in the Marrakech Accords relax the emissions targets substantially. Allowing the unrestricted use of Kyoto flexibility mechanisms further makes it much easier for the remaining Annex B Parties to meet their relaxed targets. These two factors should lower Canadian compliance costs substantially. In the meantime, the US will also incur economic losses even if it faces no mandatory constraints. Many EU countries, although awarded with fewer carbon sink credits in the Marrakech Accords than Canada, intend to do even more than the minimum that would be required under the Kyoto Protocol. The combined effects suggest that additional costs borne by Canada would appear not as high relative to those of the US and the EU as they appear at first glance.

Fifth, Canada agreed at Kyoto to a target of six percent reduction in greenhouse gas emissions on the basis of the US effort of seven percent. The question is whether US deviation from international obligations leads to no economic costs at all to the US. Given that the policy context has changed substantially from the early days of the climate change negotiations when nations were considering full Annex B implementation of the original Kyoto targets, would additional costs borne by Canada appear that high relative to the US and the EU after factoring in the sinks credits allowed in the Marrakech Accords and taking advantage of the opportunities offered by the Kyoto flexibility mechanisms?

Sixth, provided that non-Kyoto Parties like the US are seen as exploiting their lack of emissions constraints for competitive advantage, should the Kyoto Parties like Canada be allowed to give some degree of preferential treatment of their domestic companies and those of other Kyoto Parties over those of non-Kyoto Parties? If Canada, EU and other like-minded countries invoke trade measures (to meet their Kyoto targets) against another WTO member but non-Kyoto Party like the US, would these measures be upheld if challenged by the US under WTO? The Appellate Body's ruling on the Shrimp-Turtle dispute implies that requiring other WTO members to adopt a comparable regulatory program may not be inconsistent *per se* with the WTO obligation, if serious efforts were made to reach an international agreement with states whose WTO rights might be affected by an environmental policy measure. This represents a fundamental shift in WTO jurisprudence. Unless the US takes a formal step to withdraw from the UNFCCC, the US could lose some of the protections afforded it under WTO rules in any WTO dispute brought by Canada, the EU or other Kyoto Parties. A WTO Dispute Panel or the Appellate Body could, in keeping with the Vienna Convention and customary international law, deny the US legal standing to challenge policies and measures that Canada, the EU and other like-minded countries put in place to enforce the Kyoto Protocol.

It should be pointed out that the discussion in the paper focuses primarily on the first commitment period. I argue that the issue of competitiveness in the US and Canada context is a bit exaggerated. Some may share this view but still question that there might be long-term problems arising in the second and third commitment periods, provided that the US still remains outside the Kyoto regime. In my view, this is the legitimate concern, but overall competitiveness concerns mean that no country is likely to step out too far in front. Provided that the US would still remain outside the Kyoto regime at that time, it is hard to imagine that Kyoto Parties like Canada would assume future commitments that they regard overly costly and unfair.