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WTO Law as Leverage: An Inquiry into The Dynamics of Climate Negotiations Between China and The United States

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Abstract

Current U.S. "cap & trade" federal legislative proposals seek to maintain competitiveness of U.S. industry by requiring certain importers to obtain greenhouse gas (GHG) emissions permits equivalent to the permits required from U.S. producers. Currently neither U.S. nor Chinese producers are subject to such a rule. If China does not adopt what the U.S. views as a "comparable" GHG emissions permit system, it is widely expected that the U.S. Congress will require GHG emissions permit for imports. It is also widely expected that China will challenge U.S. a GHG emissions permit requirement applied to Chinese exports as in violation of WTO trade treaty obligations.

This paper examines the expected contents of U.S. competitiveness legislation in relation to WTO treaty law, and assesses prospects for WTO constraints on the U.S. GHG emissions permit system applied to Chinese exports. It also assesses the prospects for utilizing a Chinese threat of WTO legal action to bridge the gap between U.S. and Chinese positions in international climate negotiations. Under what circumstances might China adopt a GHG emissions permit system that would be accepted by the U.S. as "comparable" to the U.S. system?

Might a U.S.-China bargain include credible U.S. commitments to provide technology and technical assistance sufficient to materially reduce China's GHG emissions? Might the Clean Development Mechanism (CDM) be revised and expanded in such a way as to substantially increase the flow of CDM revenues to China? Might the U.S. and China join together in coordinated efforts to solve technical issues hampering efforts to develop "clean coal", environment-friendly biofuels, and efficient means of long-distance energy transmission?

In sum, might moderation, cooperation, and agreement be possible given increased recognition of the cataclysm threatened by uncontrolled GHG emissions, together with the leverage provided by a credible threat of potentially successful WTO litigation?

In the United States, current legislative proposals for a "cap & trade" system seek to maintain the competitiveness of U.S. industry through two basic procedures relating to GHG emissions. First, the principal draft bill pending in the U.S. Congress[2] (American Clean Energy and Security Act [ACES], 2009) would cap overall domestic GHG emissions and allocate greenhouse gas (GHG) "emission allowances" to certain carbon intensive and trade sensitive industries without charge. In this paper I will call such emission permits "domestic

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[2] The "American Clean Energy and Security Act of 2009", H.R. 2454, 111th Congress, 1st Session (hereinafter cited as "ACES"). Unless otherwise indicated, the ACES provisions cited in this paper are taken from the text of H.R. 2454 adopted on June 5, 2009, by the House Committee on Energy and Commerce. Page references are to the ACES text as reproduced in the House Energy and Commerce Committee report, H. R. Rep. No. 111-137, 111th Congress, 1st Session (2009).

At this writing the ACES bill is pending before the House Ways & Means Committee which has jurisdiction over the revenue aspects of the bill. Although the schedule has not been announced, Ways and Means may hold its "mark-up" session for amendment of the bill by the end of June. However, to become law, the bill requires acceptance both in the House of Representatives and the Senate, followed by and the all-important final reconciliation through a House-Senate conference committee. At that point the bill will be submitted to the President for signature.

emission allowances". Second, in certain circumstances, the draft bill would require importers to obtain "international emission allowances" equivalent to the domestic emission allowances required from U.S. GHG emitters. Whereas domestic emission allowances account for actual GHG emissions resulting from production and process actions in the United States, international emission allowances account for GHG emissions assumed to have resulted from production and process actions occurring abroad with respect to certain products imported into the United States.

Currently neither U.S. GHG emitters nor Chinese exporters are subject to emissions allowance requirements. However, if China or some other major exporter does not adopt what the U.S. views as a "comparable" GHG emissions allowance system, it is widely expected that the U.S. Congress will require some form of GHG emissions permit for imports of certain carbon intensive goods. It is also widely expected that China or some other exporter will challenge U.S. a GHG emissions permit requirement as applied to their exports as in violation of WTO trade treaty obligations.

This paper examines the proposed contents of U.S. competitiveness provisions in relation to WTO treaty law, and assesses prospects for WTO constraints on the proposed U.S. GHG emissions permit system. With this in mind, the paper assesses the prospects for utilizing threats of WTO legal action to bridge the gap between U.S. and Chinese positions in bilateral or international climate negotiations.[3]

The following are among the issues potentially resolvable through such a strategy. Under what circumstances might China adopt a GHG emissions permit system that would be accepted by the U.S. as "comparable" to the U.S. system? Might a U.S.-China bargain include credible U.S. commitments to provide technology and technical assistance sufficient to materially reduce China's GHG emissions? Might the Clean Development Mechanism (CDM) be revised and expanded in such a way as to substantially increase the flow of technology and of CDM revenues to China? Might the U.S. and China join together in coordinated efforts to solve technical issues hampering such carbon emissions mitigation efforts as programs to develop "clean coal" power plants, environment- friendly biofuels, or efficient means of long-distance energy transmission?

This discussion has three parts. The first is a brief description of salient provisions of "ACES", the "American Clean Energy and Security Act of 2009"[4], which is the leading climate bill pending in the U.S. Congress (ACES, 2009). At this writing, ACES has been adopted as amended by the Committee on Energy and Commerce, which is the lead House committee on energy legislation, and is pending before seven other House committees, chief among which is the House Ways and Means Committee. As the House committee primarily responsible for revenue legislation, Ways and Means will examine and perhaps amend provisions concerning both emitters' rebates and importers' emissions allowances, which are discussed in the first part of this paper.

The second part of the paper briefly examines key WTO treaty provisions to assess their potential application in WTO litigation concerning the conformity of ACES with U.S. treaty obligations. The final part will suggest that the dynamics of China-U.S. climate relations may be materially affected by the availability of a WTO forum for interpreting WTO treaty provisions and applying them to climate measures such as ACES.

The key word here is "dynamics". With the election of Barack Obama and the

[3] Although details of discussions have not been released, U.S. and British newspapers report recent meetings between U.S. and Chinese climate officials (Broder& Ansfield, 2009; Goldenberg, 2009).

[4] "Salient" refers to ACES bill provisions most closely related to treaty commitments under WTO agreements.

appointment of his "dream team" of energy and climate officials[5], the U.S. clearly expects to play a leadership role in international efforts to restrict global greenhouse gas emissions. Having surpassed the U.S. as the world's largest source of current greenhouse gas emissions, and considering its increasing need for efficient energy resources, China is similarly poised for leadership. It may well be that the success or failure of the current international climate negotiations will depend upon the ability of China and the United States to reach a common understanding and a joint approach to the design of a post- Kyoto GHG emissions control system. Hence the inquiry here addresses the dynamics of the China-U.S. climate negotiations – and the important role that might be played by WTO treaty obligations and the WTO judicial process.

American Clean Energy and Security Act of 2009 (ACES)

Although the details of a U.S. "cap and trade" system remain unsettled, there is no longer doubt that the U.S. will adopt domestic GHG controls through a "cap and trade" system. Led by Barack Obama, the U.S. government now accepts that the global warming trend is real, and that anthropomorphic GHG emissions are the principal cause of global warming. The U.S. also accepts IPCC findings that climate change affects many natural systems, including rising sea levels, altered drought and rainfall patterns, and "poleward and upward shifts in plant and animal ranges" that affect human health through "changes in infectious disease vectors"[6] (Intergovernmental Panel on Climate Change [IPCC], 2007).

ACES is essentially a lengthy omnibus bill (originally 946 pages). The bill adds a new title VII (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 131 ff) to the existing U.S. Clean Air Act: "Title VII—Global Warming Pollution Reduction Program", and names that Title together with scattered other ACES sections, the "Safe Climate Act" (ACES, 2009, § 301; H. R. Rep. No. 111-137, 2009, p. 131). The Act recites a legislative "finding" that "Global warming poses a significant threat to the national security, economy, public health and welfare, and environment of the United States, as well as of other nations" (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 131).[7] The bill's "findings" further specify that: "Because they induce global warming, greenhouse gas emissions cause or contribute to injuries to persons in the United States", including *inter alia* "disease and loss of life", "damage to property and other interests related to ocean levels", "scarcity of water", and "worsening of tropospheric air pollution" (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 131-132).[8]

The Safe Climate Act sets goals of capping and progressively reducing GHG emissions from sources specified in the bill, which includes approximately 85% of total U.S. emissions. The cap is intended to achieve to the following reductions measured as percentages of U.S. 2005 emissions: reductions in 2012 to 97%; in 2020 to 83%; in 2030 to 58%; and in 2050 to 17% of emissions from covered GHG sources (ACES, 2009, § 311; H.

[5] In contrast to the Bush administration, high officials appointed by President Obama are committed to actions that reduce and control U.S. greenhouse gas emissions. These include Steven Chu, Secretary of Energy, Gary Locke, Secretary of Commerce, Lisa Jackson, Administrator of the Environmental Protection Agency (EPA), Todd Stern, State Department Special Envoy on Climate Change, Carol Browner, White House "Climate Czar", and John Holdren, Science Adviser to the President.

[6] Intergovernmental Panel on Climate Change (IPCC), 4th Assessment Report (2007). The referenced provisions are merely a brief sample of IPCC findings. The House Energy and Commerce Committee report reviews many domestic and international impacts of climate change including the findings of climate scientists and of the IPCC (H. R. Rep. No. 111-137, 2009, p. 300-316).

[7] Adding section 701(a)(1) to the Clean Air Act.

[8] Adding section 701(a)(3) to the Clean Air Act.

R. Rep. No. 111-137, 2009, p. 132-133).[9] Although these statutory goals fall short of the rate of GHG emission reduction called for by some scientists and by some other governments, the Safe Climate Act provides a measure of flexibility through the provisions described below.

Every four years beginning in 2013, the U.S. Environmental Protection Agency (EPA) is directed to submit to Congress an analysis of the status of worldwide GHG reduction efforts based on an extensive list of the latest scientific information (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 133-134)[10] , including IPCC assessments. Beginning with its quadrennial assessment report in 2017, the EPA analysis is specifically required to include:

> … the status of worldwide greenhouse gas reduction efforts, including implementation of … policies, both domestic and international, for reducing greenhouse gas emissions, preventing dangerous atmospheric concentrations of greenhouse gasses, preventing significant irreversible consequences of climate change, and reducing vulnerability to the impacts of climate change (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 133).[11]

The quadrennial EPA assessment must specifically address whether the actions of the United States and other countries are "sufficient to avoid"

> (A) atmospheric greenhouse gas concentrations above 450 parts per million carbon dioxide equivalent; [and]
> (B) global average surface temperature 3.6 degrees Fahrenheit (2 degrees Celsius) above the pre-industrial average, or such other temperature thresholds as the [EPA] Administrator deems appropriate (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 135).[12]

As noted below, the bill's specifications of 450 ppm and 2 degrees Celsius as thresholds of dangerous atmospheric GHG concentrations do not reflect an international scientific consensus. Nevertheless some flexibility is provided by the authority of the EPA Administrator to find that some other temperature threshold is appropriate in light of an emerging scientific consensus.

Most importantly, each quadrennial EPA report must specify the quantity of additional global reductions in GHG emissions that would be needed to avoid exceeding the GHG concentration and the temperature thresholds specified in the bill or by the EPA Administrator (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 135).[13] Furthermore, the bill calls upon the premier independent scientific body in the United States, the National Academy of Sciences (NAS)[14], to review the EPA quadrennial report, and to analyze the

[9] Adding 703 to the Clean Air Act.
[10] Adding 703 to the Clean Air Act, House Report pp. 132-33.
[11] Adding section 705(a)(3) to the Clean Air Act.
[12] Adding section 705(e)(2)(A) & (B) to the Clean Air Act.
[13] Adding section 705(f)(3)(B) to the Clean Air Act.
[14] The NAS by legislation signed by President Abraham Lincoln in 1863. As mandated in its Act of Incorporation, the NAS role is to "investigate, examine, experiment, and report upon any subject of science or art" whenever called upon to do so by any department of the government. NAS membership is composed of approximately 2,100 members and 380 foreign associates, of whom nearly 200 have won Nobel Prizes. Members and foreign associates are elected in recognition of their distinguished and continuing achievements in original research. The Academy is governed by a Council consisting of twelve members (councilors) and five officers, elected from among the Academy membership. [Based on the Academy website www.nasonline.org.]

technologies that would be needed to achieve the GHG emission reductions recommended by the EPA. Both the EPA quadrennial report and the National Academy analysis are to be submitted to Congress (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 135).[15] As is normal under United States law, each of the many federal agency reports in the climate review process will be available to the public, and several committees of the Congress will likely hold public hearings when additional GHG emissions restrictions are proposed.

Finally, at the White House level, two years after each quadrennial EPA report, the President is required to "direct relevant Federal agencies to use existing statutory authority to take appropriate actions identified" in the EPA quadrennial assessments (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 135).[16]

Furthermore,

> [I]n the event that the National Academy of Sciences has concluded … that the United States will not achieve the necessary domestic greenhouse gas emissions reductions, or that global actions will not maintain safe global average surface temperature and atmospheric greenhouse gas concentration thresholds, the President shall submit to Congress a plan identifying domestic and international actions that will achieve necessary additional greenhouse gas reductions, including any recommendations for legislative action (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 135).[17]

As is normal in so wide-ranging a legislative effort as ACES, ultimate control over changes in U.S. GHG emissions policy would be reserved to Congress. However, insofar as the GHG emissions cap is concerned, ACES vests considerable influence, regulatory authority, and operational control in EPA, which is an administrative agency within the Executive Branch. The quoted ACES provisions delegate to the EPA and also to the nongovernmental expert body, the National Academy of Sciences, two crucial issues rolled into a single question: whether the statutory danger thresholds and existing GHG emission controls are adequate to avoid climate catastrophe. While the adequacy of the danger thresholds may be addressed in terms of climate science, the question of the appropriate governmental response raises issues of societal values.

Much is now known about the climate change consequences of global warming, but the point at which atmospheric concentrations of GHG emissions could cause "runaway" GHG emissions remains subject to sharp differences of opinion among climate scientists. An example would be the loss of heat-reflective ice cover in Greenland and Antarctica, which would accelerate surface warming in Arctic and Antarctic regions. This would potentially cause vast areas of permafrost to melt, releasing large amounts of the potent greenhouse gas methane. Such an event has been seen as a so-called "tipping point" at which runaway GHG emissions can no longer be brought under control (H. R. Rep. No. 111-137, 2009, p. 297-298).

Through the statutory reference to "global actions [that] will not maintain safe global average surface temperature and atmospheric greenhouse gas concentration thresholds", Congress plainly calls upon the EPA and the National Academy of Sciences to assess the adequacy of the statute's danger thresholds: atmospheric concentrations increase to 450 ppm CO2 equivalent, and global average surface temperature increase of 2 degrees Celsius. Since these benchmarks function as the basis for the ACES GHG emissions cap, such a finding would imply an urgent need for more stringent measures to reduce carbon emissions. But

[15] Adding section 706(a) to the Clean Air Act.
[16] The first occasion for Presidential action thus comes in 2015. Adding section 707(1) to the Clean Air Act.
[17] Adding section 707(2) to the Clean Air Act.

climate science can do no more than address the risk in terms of greater or lesser degrees of confidence (IPCC, 2005). Governments responding to such risks need to evaluate proposed measures in light of societal values.

If the EPA or the NAS were to determine that existing measures are not adequate to avoid danger levels, the operational question then becomes: what measures would be needed to maintain GHG emissions levels below the amount projected to exceed the danger point? Implicit in this issue is the degree of risk that would be responsible in light of the potential for harm resulting from exceeding a "tipping point". The stringency – and therefore the costs – of a government's response to such a risk more directly concerns societal values, which will be addressed by Congress, but are not likely to be the subject of international negotiation.

In this scenario it may be difficult to separate scientific issues from values issues, but such a separation is needed for clarity of analysis. The causal links between GHG emissions, climate change, and its consequences, are now subject to a growing body of scientific evidence – which increasingly provides a solid basis for policy analysis. In contrast, the value basis for tolerable risk levels is not subject to scientific analysis. Each government must clarify its societal values and strive for transparency in its choice of responsive measures. Care must be taken to view science – determining the causes and consequences of climate change – independently of societal values that structure tolerable risk levels and appropriate responses.

Structure of the ACES Emission Allowances Program

Beginning in 2012, the ACES emission allowance requirement applies to "covered entities" which include all electricity generators, and producers or importers of petroleum- or coal-based liquid fuels, or natural gas liquids where combustion of the fuel results in emission of more than 25,000 metric tons of carbon dioxide equivalent annually. In 2014 the emission allowance requirement is extended to industrial facilities that manufacture certain products or that burn fossil fuels at the same 25,000 metric ton emission standard as applied to producers of liquid fuels. Certain natural gas distributors are also covered entities beginning in 2016.[18]

The ACES emissions cap is structured to begin with issuance by the EPA Administrator in calendar year 2012 of the number of emission allowances equivalent to 97% of the GHG emissions by covered entities in 2005. The number of emission allowances issued in 2012 (about 4.6 billion) rises to about 5.5 billion in 2016 as additional facilities become subject to the emission allowance requirement. The emissions cap then tightens; the number of allowances issued drops by roughly 100 to 150 million per year until it reaches slightly over 1 billion for the year 2050 and following years (ACES, 2009, § 311; H. R. Rep. No. 111-137, 2009, p. 143-144).[19]

Although the Obama administration had originally wanted emission allowances to be auctioned with the auction revenue included in the federal government budget, the House Energy and Commerce Committee bill would initially auction less than 30 percent of emission allowances, which would drop to 17.5% by 2016 as additional entities became covered by the emissions cap. The remainder, i.e., 82.5% in 2016, would be distributed free of charge (H. R. Rep. No. 111-137, 2009, p. 362).

From 2016 through 2025, 35% of the emission allowances would be allocated to the electricity sector without charge for the benefit of electricity consumers, and 9% would be allocated for the benefit of natural gas consumers. In addition, for each year, 2012 through 2050, 15% of the emission allowances would be allocated for the benefit of low income

[18] Covered entities are more fully described in H. R. Rep. No. 111-137, 2009, pp 360-361.
[19] Adding section 721(e) to the Clean Air Act.

consumers. ACES provides for many other generally much smaller free allocations of emissions allowances for various purposes and varying time periods. These include home heating oil and propane consumers, support for carbon capture and sequestration, investment in energy efficiency and renewable energy, and rebates to certain energy-intensive, trade-exposed industries (ACES, 2009, § 321; H. R. Rep. No. 111-137, 2009, p. 177-180).[20] An economist who recently examined ACES allowances, their intended recipients, the purposes for which they would be issued, and the varying free distribution periods and percentages concluded that "80% of the value of [freely distributed emission allowances] accrue to consumers and public purposes, and some 20% accrue to covered, private industry." (Stavins, 2009). [21]

Emission Allowance Rebate and International Reserve Allowance Programs

In addition to freely distributed emission allowances, ACES establishes two programs that address the competitiveness impacts of the U.S. industry in light of the costs of the cap-and-trade program. First, the "Emission Allowance Rebate Program" provides rebates to certain industrial sectors to compensate for costs incurred in compliance with ACES emission limits. Second, the "International Reserve Allowance Program" authorizes the President to require that in certain circumstances, importers of certain products obtain "international reserve allowances" intended to address the competitive imbalance in the costs of production resulting from the difference between costs of complying with ACES and the costs, if any, of complying with GHG emission programs in other countries (ACES, 2009, § 401; H. R. Rep. No. 111-137, 2009, pp. 229-230).[22]

The basic purpose of the Emission Allowance Rebate Program is stated to be preventing "carbon leakage" by rebating the bill's GHG emission costs to firms in eligible domestic industrial sectors. "Carbon leakage" is defined as a "substantial increase" in GHG emissions "in other countries" if such increase is caused by a cost of production increase in the U.S. resulting from implementation of the ACES legislation (ACES, 2009, § 401; H. R. Rep. No. 111-137, 2009, p. 225).[23] To be eligible for a rebate, the firm must be in an industrial sector that satisfies one of the following two criteria:

> First. the sector must have *either* an "energy intensity" *or* a "greenhouse gas intensity" of at least 5%[24], *plus* a trade intensity of at least 15%[25]; or,
> Second, the sector must have a "very high energy or greenhouse gas intensity of at least 20% (ACES, 2009, §764(b)(2)(A)(ii); H. R. Rep. No. pp. 226).[26]

Calculations formulae (summarized in footnotes) show that access to rebates

[20] Emissions Allowance Rebate Program, adding section 782 to the Clean Air Act. The rebate program is separately described below.

[21] The writer states that his analysis is based on the Waxman-Markey ACES bill as amended by the House Energy and Commerce Committee.

[22] International Reserve Allowance Program, adding sections 766-767 to the Clean Air Act.

[23] Adding section 763(1) to the Clean Air Act.

[24] To calculate "energy intensity", *divide* (the cost of purchased electricity + fuel costs of the sector) *by* the (value of the shipments of the sector). To calculate "greenhouse gas intensity", *divide* [the number 20 *multiplied by* (the number of tons of direct and indirect CO2 equivalent GHG emissions)] *divided by* (the value of the shipments of the sector) (ACES, 2009, §764(b)(2)(A)(i); H. R. Rep. No. pp. 225-226).

[25] To calculate "trade intensity", *divide* (the value of total imports and exports of the sector) *by* (the value of shipments + the value of imports of the sector) (ACES, 2009, §764(b)(2)(A)(ii); H.R. Rep. No. 111-137, p. 226).

[26] Note that the criteria given here indicate *presumptively* eligible sectors; the EPA may designate additional eligible sectors. (ACES, 2009, §764(b)(3); H. R. Rep. No. pp. 227).

increases as either the sector's energy costs or its GHG emissions increase; trade intensity increase similarly increases access to rebates as either or both imports and exports increase.

The ACES Emission Allowance Rebate Program includes both "covered entities"[27] and firms that are not "covered entities", but operate in an eligible industrial sector that satisfies the criteria summarized above. Calculation of rebates differs according to whether the industrial entity is or is not a "covered entity".

For covered entities, rebates include both direct and indirect compliance costs, which are termed "direct and indirect carbon factors". Rebates for other industrial firms in an eligible sector are measured solely by indirect compliance costs. Direct compliance costs are carbon emission costs incurred by covered entities; indirect compliance costs are carbon emission costs passed along to both covered entities and other eligible entities by their electricity providers. Where emissions allowances were freely allocated to an electricity provider and used for the benefit of industrial consumers, rebates for indirect costs are adjusted to avoid rebates for costs that were not incurred by the industrial entity (ACES, 2009, §765(b)(1)-(3); H.R. Rep. No. 111-137, p. 228-229). The total distribution of rebates for any year is limited to the amount of emission allowances allocated to the Emission Allowance Rebate Program for that year (ACES, 2009, §321; H.R. Rep. No. 111-137, p. 178).[28]

As noted earlier, the ACES bill also provides for an "International Reserve Allowance Program" that authorizes the President to require importers' "international reserve allowances" intended to address the competitive imbalance resulting from the difference between costs of complying with ACES, and the costs of complying with a GHG emission program, if any, in the exporting country. The program applies to imports of "primary products" which are defined as products manufactured by an eligible industrial sector that are:

> (A) iron, steel, steel mill products (including pipe and tube), aluminum, cement, glass (including flat, container, and specialty glass and fiberglass), pulp, paper, chemicals, or industrial ceramics; or
>
> (B) any other manufactured product that is sold in bulk for purposes of further manufacture or inclusion in a finished product (ACES, 2009, §401; H.R. Rep. No. 111-137, p. 225).[29]

To invoke the international reserve allowance requirement with respect to imports of primary products in an eligible industrial sector, the President must first determine whether 70% or less of the global output[30] for the sector is produced or manufactured in countries that meet at least one of the following four criteria (ACES, 2009, §767(c); H.R. Rep. No. 111-137, p. 230):

> 1. The country is a party to an international agreement to which the United States is a party that includes a nationally enforceable greenhouse gas emissions reduction commitment for that country that is at least as stringent as that of the United States.

[27] "Covered entities" are defined in ACES section 312, adding Title VII to the Clean Air Act. (ACES, 2009). Also see the summary description earlier in this paper.

[28] Adding section 782(e) to the Clean Air Act, concerning "Trade Vulnerable Industries". The allocation is 2% of the emission allowances for 2012 and 2013, but 15% for the year 2014, and 15% multiplied by various factors for subsequent years.

[29] Adding section 763 to the Clean Air Act.

[30] Output means "the total tonnage or other standard unit of production (as determined by the [EPA] Administrator) produced by an entity in an industrial sector." (ACES, 2009, §763(5); H.R. Rep. No. 111-137, p. 222).

> 2. The country is a party to a multilateral or bilateral emission reduction agreement for that sector to which the United States is a party.
>
> 3. The country has an annual energy or greenhouse gas intensity … for the sector that is equal to or less than the energy or greenhouse gas intensity for such sector in the United States in the most recent year for which data are available.
>
> 4. The country has implemented policies … that individually or collectively impose an incremental increase on the cost of production associated with greenhouse gas emissions from the sector that is at least 60% of the cost of complying with this title in the United States for such sector, averaged over a two-year period (ACES, 2009, §767(b); H.R. Rep. No. 111-137, p. 230).

Next, the President must assess the extent to which either emission allowance rebates or the International Reserve Allowance Program either has or could mitigate or address carbon leakage in the industrial sector at issue (ACES, 2009, §767(c); H.R. Rep. No. 111-137, p. 230).

Upon making the 70% or less finding and the emission allowance and reserve allowance assessments, the President must then either modify the percentages that govern the direct and indirect carbon cost factors in calculating the emission allowance rebate, or implement the International Reserve Allowance Program for the primary products involved, or take both actions (ACES, 2009, §767(c)(3) and (e); H.R. Rep. No. 111-137, p. 231).

ACES provides that the International Reserve Allowance Program may not begin before January 1, 2025 (ACES, 2009, §766(a)(4); H.R. Rep. No. 111-137, p. 230). It is in essence a border adjustment program with the stated purpose of addressing "the competitive imbalance in the costs of producing or manufacturing primary products in industrial sectors resulting from the difference between" US GHG emission compliance costs and the "costs, if any, of complying in other countries with greenhouse regulatory programs" (ACES, 2009, §766(a)(2); H.R. Rep. No. 111-137, p. 230). Regulations issued by the EPA Administrator would require submission of "appropriate amounts" of international reserve allowances on importation of primary products, and prohibit "the introduction into interstate commerce of a primary product without submitting the required number of international reserve allowances" (ACES, 2009, §766(a)(1)(B) and 766(a)(1)(D); H. R. Rep. No. pp. 229-230).

WTO Treaty Compliance Issues

Brief comments about WTO jurisprudence may be useful before addressing WTO treaty compliance issues under key ACES provisions. The three ACES provisions that appear most vulnerable are: (1) The ACES grant of free allocations of emissions allowances; (2) the "Emissions Allowance Rebate Program"; and (3) the "International Reserve Allowance Program". Each provision is summarized above.

The WTO judicial process is more complex than that of other major international tribunals. In brief, there are four phases to the WTO judicial process: consultations between the parties; proceedings before a Panel; appeals to the Appellate Body; and compliance proceedings. Unlike the International Court of Justice, where the consent of the respondent state is required, WTO Members are obligated by treaty to submit their WTO treaty disputes to the jurisdiction of WTO tribunals. Although they do not bind other WTO Members, decisions of the Appellate Body – and, where not appealed, of WTO Panels – are binding with respect to the states parties to the dispute.

Under the WTO Dispute Settlement Understanding (DSU), the fundamental role of the WTO judicial system is to provide "security and predictability to the multilateral trading

system." Hence the purpose of the WTO legal process is "to preserve the rights and obligations of Members under the covered agreements and to clarify the existing provisions of those agreements in accordance with the customary rules of interpretation of public international law." Article 3.2 adds that WTO dispute settlement rulings "cannot add to or diminish the rights and obligations provided in the covered agreements." (DSU, 1994, Article 3:2).

Thus, although WTO dispute decisions are to "clarify" existing WTO treaty provisions, they must "preserve" rights and obligations, without increasing or reducing those rights or obligations. This careful formulation appears to impose sharp limits on the "clarification" function of dispute settlement, but Article 3.2 structures those limits by mandating that the twin tasks of clarification and preservation be accomplished "in accordance with the customary rules of interpretation of public international law." (DSU, 1994, Article 3:2). In common with international practice generally, the Appellate Body reasonably accepts that customary international law rules of treaty interpretation are embodied in Articles 31-33 of the widely ratified Vienna Convention on the Law of Treaties (1969) ("Vienna Convention" or "VCLT") (*Japan—Taxes on Alcoholic Beverages*, 1996). Also in common with international practice generally, the Appellate Body acknowledges that some existing rules of treaty interpretation have not been codified in the Vienna Convention (*United States—Continued Dumping and Subsidy Offset Act*, 2000, ¶271).

I should emphasize that treaty interpretation is not a mechanical process that can be accomplished by routine application of clear rules or standards of interpretation to the text of a treaty. Rather, treaty interpretation requires close analysis of the treaty text, deep understanding of treaty interpretation methodology, and sophisticated appreciation of the limits to the interpreter's authority. Thus it is by no means assured that but a single "correct" result will be reached in any specific instance. What is desired and should generally be attainable, however, are interpretations that fall within a relatively narrow band of potential results.

In interpreting provisions of WTO agreements, the Appellate Body has often been quite rigorous and systematic in applying the "rules" of interpretation laid down in Articles 31-33 of the Vienna Convention on the Law of Treaties. Paradoxically, the Appellate Body's focus on rigorous application of international law treaty interpretive methodology is sometimes criticized from both ends of the spectrum: either as far too mechanical an approach or as enabling the Appellate Body to create law by masking insertion of its own unwarranted trade policy judgments into WTO agreements. Neither polar criticism is justified.

Typically Appellate Body review forcefully requires panels to begin with the "*ordinary meaning*" of the treaty text as mandated by VCLT Article 31:1, which calls for interpreting treaty text in light of "*context*" as is narrowly defined in VCLT Article 31:2, and in light of the "object and purpose" of the treaty. The net effect of these provisions is to focus the interpreter's attention on matters intrinsic to the treaty. Although these provisions constitute the "fundamental rule" of treaty interpretation, both panels and the Appellate Body typically need to resort to other provisions of the VCLT, and sometimes to canons of treaty interpretation found in customary international law outside of the Vienna Convention.

The concept of "*ordinary meaning*" is not defined. Although determining "ordinary" meaning will typically require the interpreter to invoke dictionary definitions of the language used in authentic treaty texts, the Appellate Body has observed that:

> [D]ictionaries, alone, are not necessarily capable of resolving complex questions of interpretation, as they typically aim to catalogue *all* meanings of words—be those meanings common or rare, universal or specialized (*United States—Gambling*

Services, 2005, ¶¶ 162-66).

A focus intrinsic to the treaty is equally clear in deriving meaning from the "*context*" of a contested term. Although the term "context" may often bear a broader meaning, the Vienna Convention gives the concept a narrow scope. VCLT Article 31:2 defines "context" as meaning the treaty text, including its preamble and annexes, together with agreements "relating to the treaty … made between all the parties in connexion with the conclusion of the treaty".

Article 31 also permits the interpreter to consult three other potential indicators of agreement of the parties regarding the interpretation of the treaty. The first is "any subsequent agreement" "regarding the interpretation of the treaty"; the second is "any subsequent practice" "which establishes the agreement of the parties regarding its interpretation" VCLT Article 31:3(a) & (b). The third reference is to "any relevant rules of international law applicable in the relations between the parties" VCLT Article 31:3(c). The interpreter's use of subsequent agreements and subsequent practice moves analysis beyond the text of the treaty, but the focus remains the text the treaty as drafted; to be considered by the interpreter, both subsequent agreements and subsequent practice must relate directly to the interpretation of the treaty. Hence the interpreter's resort to these factors is not a substantial departure from the concept of deriving meaning from indicators of intent "intrinsic" to the treaty.

Free Allocation of Emissions Allowances and Emission Allowance Rebate Program

To challenge free allocation of emissions allowances or the emission allowance rebate program as in violation of the WTO Agreement on Subsidies and Countervailing Measures (Subsidies or SCM Agreement), a WTO Member would need to show that the ACES measures constitute a "subsidy" and cause "adverse effects" to the interests of other Members as those terms are defined in the Subsidies Agreement.

The SCM definition of a "subsidy" includes, *inter alia*, the following potentially relevant forms of a "financial contribution by a government":

> (i) a government practice [that] involves a direct transfer of funds (e.g. grants, loans, and equity infusion) …;
>
> (ii) government revenue that is otherwise due is foregone or not collected …;
>
> (iii) a government provides goods or services other than general infrastructure…. (SCM Agreement, 1994, Article 1.1(a)(1)(i)-(iii)).

To be "actionable", the subsidy must be "specific" in the sense of applying to "enterprise or industry or group of enterprises or industries", in contrast to grants made pursuant to legislation which "establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy". Furthermore, an "actionable" subsidy requires, *inter alia*, "serious prejudice to the interests of another Member", which may arise where "the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member"(SCM Agreement, 1994, Articles 2.1, 2.1(b), 5(c), and 6.3(a)). The quoted provisions may serve as the WTO treaty basis for a multifaceted challenge to the wide-ranging free allocation of emission allowances in the

ACES bill.[31]

If a subsidies case were brought by an exporter of goods to the U.S. market, the United States may seek to invoke the environmental exception of the General Agreement on Tariffs and Trade (GATT) Article XX(g), which provides:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> . . .
>
> *(g)* relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption; ….

Although the Subsidies Agreement adopted at the Uruguay Round in 1994 relates to certain articles in the original GATT agreement adopted in 1947, the GATT Article XX "General Exceptions" do not explicitly apply to the other Multilateral Agreements on Trade in Goods adopted at the Uruguay Round. Hence, quite apart from difficulties in interpreting the language of the introductory clause, termed the "chapeau" of Article XX, and its subparagraph (g), reliance on the General Exception of GATT Article XX may be rejected as a defense to claimed Subsidies Agreement violations.

The Emission Allowance Rebate Program presents much the same subsidy issues as presented by the free allocation of emission allowances, but the WTO analysis may differ owing to the specifications of the program. The eligibility tests imply more limited access to rebates in comparison to the wide scope given to free allocation of emission allowances. The focus on "carbon leakage", defined as a "substantial increase" in GHG emissions "in other countries" if such increase is caused by a cost of production increase in the U.S. resulting from implementation of the ACES legislation, implies that "leakage" refers to a shift of production to countries that do not limit GHG emissions. This might be seen as a "disguised restriction on international trade", disqualifying the program for the "general exception" provision of GATT Article XX(g).

Both measures, the free allocation of emission allowances and the Emission Allowance Rebate Program, thus offer considerable scope for WTO legal challenge, involving issues of interpretation and application of WTO treaties that are not easily answered.

The International Reserve Allowance Program offers additional potential legal challenges which, if anything, would be more complex than those arising under the free allocation and emission allowance rebate programs.

As noted, the International Reserve Allowance Program is explicitly intended to address the competitiveness of U.S. industry – the competitive imbalance that results from the difference between costs of complying with ACES, and costs of complying with a GHG emission program, if any, in the exporting country. The program would correct this imbalance – level the playing field – by requiring exporters to acquire emission allowances from the "International Reserve" established by the EPA Administrator.

The fundamental issue presented by the International Reserve Allowance Program is that imports from WTO Members that control GHG emissions in a manner similar to the U.S. are treated differently from exports from WTO Members that have not adopted such

[31] See text regarding Emissions Allowance Rebate Program, above.

controls. GATT Article I:1, General Most-Favoured-Nation Treatment, provides:

> With respect to customs duties and *charges of any kind* imposed on or in connection with importation . . . any advantage, favour, privilege or immunity granted by any [WTO] Member to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the *like product* originating in or destined for the territories of all other [WTO] Members. [italics supplied][32]

The italicized words "*charges of any kind*" and "*like product*" raise the issues of whether the international emissions allowance requirement is in effect a "charge", and whether a product produced with GHG emission controls is "like" an identical product produced without such controls. The latter is the product versus process or production methods (PPM) issue which has arisen several times under GATT and WTO, but has yet to be finally resolved. Once again these issues provide ample opportunity for WTO litigation.

In addition, the International Reserve Allowance Program presents potential barriers to satisfying the requirements of the chapeau to Article XX. The General Exception clauses of GATT Article XX would of course apply to measures that violate the MFN clause of GATT Article I, but the question may be whether ACES International Reserve provisions violate the chapeau because "applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade". Since the International Reserve Allowances Program explicitly seeks to correct competitive trade "imbalances", its application will surely seek to restrict international trade, and it may be no defense that the program is not effective until January 1, 2025. The terms of the Article XX chapeau seem to contemplate a measure that has been "applied", which may be argued to postpone analysis until sometime after the effective date for the President's invocation of the International Reserve Allowance Program. Owing to their "chilling effect" on international trade, however, the WTO has, however, adjudicated cases challenging statutory provisions before they were implemented.

WTO Litigation as Leverage in Climate Negotiations

This brief survey of potential WTO legal challenges to ACES provisions is intended to show that the adoption of ACES may trigger potentially well-founded WTO cases unless agreement on GHG controls can be reached between major trading partners. In this context, potential WTO litigation may serve as an impetus to reaching broader agreement on climate issues. The filing of WTO cases will set in motion a lengthy and contentious process that might harden government positions, threaten the WTO dispute settlement system, and become yet another barrier to reaching climate agreement. Might moderation, cooperation, and agreement be possible given increased recognition of the cataclysm threatened by uncontrolled GHG emissions, together with the leverage provided by a credible threat of potentially disruptive WTO litigation?

Perhaps a credible threat of WTO climate litigation would add to the pressure on the United States to reach consensus on a post-Kyoto GHG emissions control regime. One scenario for reaching a broader agreement might be serious planning for a WTO challenge to the ACES legislation – planning that would necessarily be taken seriously by the United States which has always had high stakes in effective WTO trade regulation. Facing such a

[32] The original language of GATT Article I:1 referring to "contracting parties" was changed to WTO Members with the establishment of WTO (GATT 1994, ¶ 2(a), Explanatory Notes).

challenge, perhaps the United States may be willing move towards effective transfer of GHG emissions reduction technology to developing countries and even to entertain proposals for joint China-U.S. projects aimed at developing technology to address major GHG emissions reduction issues.

Some examples follow: With abundant coal resources, both China and the U.S. would profit from cost-effective carbon capture and sequestration. With rising pressures on food resources, and concerns about energy independence, both China and the U.S. would profit from cost-effective cellulosic ethanol production. With urgent plans to develop and market the plug-in electric car, both China and the U.S. would profit from improvements in electric storage battery technology. With rapid development of wind and solar power, both China and the U.S. would profit from cost-effective long-distance energy transmission.

China-U.S. cooperative research projects in any one of these fields, and in many others, could develop and disseminate needed technology, thereby contributing to the reduction of global GHG emissions. Research costs might be shared in proportions agreed between the two sides, and research facilities could be located in both countries. As is normally true of U.S. government sponsored research, technology developed in such projects should be placed in the public domain, available without cost to researchers and manufacturers in all countries.

In embarking on such joint research projects, both China and the United States would at least informally agree on the contours of a post-Kyoto climate agreement in which all participants would undertake to accept limitations on their GHG emissions and to develop national emission allowance trading schemes compatible with those of their treaty partners. The participants would also agree to accept border adjustments as GHG emission compliance mechanisms, and to support the adoption by the WTO Ministerial Conference of a climate-friendly interpretation of "like product" in relevant WTO agreements (Agreement Establishing the World Trade Organization, Article IX:2).[33]

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[33] Granting the WTO Ministerial Conference and General Council "exclusive authority to adopt interpretations … of the Multilateral Trade Agreements [by a three-fourths majority of WTO Members]." Since the authority granted is "exclusive", the WTO Appellate Body would no doubt accept a Ministerial Conference interpretation.

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