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NUMBER OF PAGES, INCLUDING THIS PAGE: 5

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FROM:

NAME: Susan Wickwire TEL: (202) 647-4069 /4283 (direct)

OFFICE OF GLOBAL CHANGE FAX: (202) 647-0191

OES/EGC - RM. 4330

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MESSAGE:

On behalf of my colleague, Dan Balzer (who is already in Moscow), I am sending to you for your clearance by noon tomorrow (1/20) a set of draft points for use by Mr. Nitze at the Environment Committee meeting on Thursday a.m. I will forward to Dan any comments/changes etc. Thanks in advance.

DRAFT

Climate Change Talking Points
Environment Committee of the Gore-Primakov Commission
January 21-22, 1999
Moscow

- Climate change remains a high personal priority of Vice President Gore.
- The United States has been very pleased with the excellent relationship that has developed between our two countries on this issue.
- I would like to note that we currently have delegations in Canberra for a meeting of the Umbrella Group.
- We have been very pleased with the development of the Umbrella Group. Our solidarity in Buenos Aires in November was instrumental in securing a forward-looking Plan of Action, in heading off the movement by other Parties to impose quantitative caps on the use of the Kyoto mechanisms, and in advancing the consideration of commitments by developing countries.
- With regard to the Kyoto Mechanisms -- and especially emissions trading and joint implementation -- which are of particular importance to both the United States and the Russian Federation, there are a number of issues we might discuss.
- Setting the rules under the Protocol for the Kyoto Mechanisms is one of our highest priorities in the Buenos Aires Action Plan.
- In particular, the setting of rules and guidelines for emissions trading will be essential to establish the credibility of such a system.
- Also essential for the success of emissions trading will be the capacity of Parties to measure, report, and verify their national emissions -- this is an area of particular concern for the Russian Federation.
- We also recognize Russia's need for the resources to finance such investments in measurement, reporting, and verification.
- At the same time, we are aware that emissions trading still faces some opposition within the international negotiations, particularly over the question of whether or not emissions trading will produce an environmental benefit.
- One criticism of emissions trading in the international negotiations relates to the likelihood that Russia's and other Parties' baseline emissions will fall below their allocated amounts during the first commitment period, and that international trading of these amounts will therefore not reduce global emissions of greenhouse gases.
- These factors have contributed to a level of uncertainty about what an international emissions trading system under the Kyoto Protocol will look like, and this uncertainty is

inhibiting development of an early trading market.

- Generating some early trades would significantly bolster confidencc in the ability of emissions trading to help reduce global emissions while generating needed revenue and investment where it would be most effective and where it is most needed.
- We noted that during the emissions trading workshop in Moscow last July there was some informal discussion on the Russian side about using a portion of the revenue derived from emissions trading for environmental purposes.
- I believe it may be useful to consider explicitly dedicating a portion of the proceeds realized from selling those emissions allocations that exceed the Russian Federation's baseline toward environmental purposes.
- Doing so could be very helpful in the multilateral negotiations in responding to critics of Russia's emissions target in the Protocol's first commitment period, and also remove one source of opposition to emissions trading.
- I would like to share with you some thoughts we have had within the U.S. Government about how some early trade in emissions allocations might be generated in a manner that would avoid a number of the uncertainties that appear to be inhibiting early trading currently.
- Because of the high degree of uncertainty in the market with regard to trade in emissions allocations themselves, an early transaction might consist of the Russian Federation selling to an American firm the option to purchase a specified portion of Russia's allocated amount.
- The actual purchase and transfer of emissions allocations would take place at an agreed-upon future date, such as entry into force of the Kyoto Protocol or the start of the first commitment period.
- Selling options to purchase would generate revenue for the Russian Federation now.
- Russia could use a portion of these proceeds to help finance development of the national emissions measurement and reporting system needed for compliance and trading eligibility under the Kyoto Protocol.
- Proceeds could also go toward early investment in measures to reduce greenhouse gas concentrations such as energy-saving plant modernization or carbon sequestration projects.
- The actual purchase price might be specified in advance, or could be linked to the international market price for tons of carbon emissions at the time of purchase -- the mechanism for determining the price would be subject to agreement between the Russian Federation and the U.S. firm buying the option.
- An early transaction like this one could help achieve a number of important objectives in establishing an emissions trading system:

DRAFT

-- It would generate early revenue for the Russian Federation;
-- It could stimulate private sector interest in investing in emissions reduction in the Russian Federation.
-- It could remove some of the international opposition to emissions trading by demonstrating concretely how trading can lead to an environmental benefit.

- In connection with this early transaction between the Russian Federation and private companies, the United States Government could make a matching contribution to the development of Russian emissions measurement and reporting systems.
- The U.S. Government will also support legislation to give credit for early trading, which we believe will help attract the interest of U.S. firms.
- We do not yet have a formal proposal to present, but wanted to share with you our current thinking and hear any preliminary thoughts you might have.
- We will be consulting with a number of U.S. firms about their potential interest in participating in such an arrangement.
- If you are interested in pursuing transaction along these lines, we can discuss it further at next meeting of the Environment Committee and perhaps task our Climate Policy Working Group with working out some of the details.

Drafted: OES/EGC:DBalzer (comments to Susan Wickwire, 647-4069) 1/15/99
4293 (direct)

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The EPA is taking steps NOW to ensure no disruption in service or environmental protection occurs when our data systems convert to the year 2000. We are preparing for the year 2000 --- are you?

Ressig papers - for the meeting Thursday @ 1:00 pm

Page 1 of 6 (including cover sheet)

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Possible Framework for Early Greenhouse Gas Emissions Trading Agreements with Russia

Purpose of Early Trading Agreement

This paper describes a potential agreement between the U.S. and the Russian Federation on a framework for early international emissions trading under the Kyoto Protocol. The agreement would allow U.S. private sector firms to make early contracts with the Russian government (or legal entities empowered by the Russian government) for purchase of GHG emissions allowances drawn from the Russian emission budget under Kyoto. U.S. firms could use these allowances to substantially reduce the costs of meeting potential GHG reduction obligations. On the seller's side, Russia would agree to dedicate proceeds from these early contracts to (1) early development of the national emissions measurement and reporting system needed for compliance and trading eligibility under Kyoto, and (2) early investment in GHG reducing measures such as energy-saving plant modernizations, as well as in forest carbon sequestration projects — investments that would improve the Russian economy and further reduce GHG emissions.

Since it is not our intention to be exclusive, this agreement could also be open to other potential seller countries (principally the Ukraine) and to the private sector in other potential buyer countries (members of the Umbrella Group and beyond). This framework could lead to early market activity that benefits all participants and helps get international emissions trading "off the ground."

How Would Early Trading Work?

An early trading framework agreement would allow a U.S. private entity (or entity from another buyer nation) to enter into a contractual commitment with the government of the Russian Federation (or another seller nation, such as the Ukraine) for future delivery of GHG emission allowances drawn from the seller country's "assigned amount" under the Kyoto Protocol. The contract would commit the seller government to transfer an agreed-upon number of tradeable allowances (denominated in one-ton units of carbon dioxide equivalent) to the buyer firm; the actual transfer of the allowances would take place at a specified time, probably following the seller country's ratification of the Kyoto Protocol. In exchange, the buyer firm would pay a portion of the purchase price "up front" and the remaining amount upon actual delivery of the allowances.

The framework agreement would also include a specific commitment by the Russian Federation (or other sellers) to dedicate the proceeds of early trading to two purposes: (1) the development of the monitoring and reporting infrastructure that they will need in order to be eligible to trade under the international trading rules being negotiated in follow-up to Kyoto; and (2) investment in concrete modernization and efficiency projects to further reduce their emissions and in projects to increase absorption by forests and other sinks.

As an alternative to paying the proceeds into the dedicated fund, the agreement could also provide for buyer firms to make direct investments in specific modernization or efficiency projects (i.e., "joint implementation" projects) in return for a legal commitment for future delivery of tradeable allowances by the seller government.

The agreement could also include commitments by Russia (or other sellers) to take concrete steps to remove current barriers to direct investments in emission reduction and absorption projects.

Participation by U.S. private entities would be entirely voluntary. The proposal does not involve any transfer of U.S. government funds to the Russian Federation (or other sellers) for purchase of allowances, although limited technical assistance from USAID/EPA/DOE would be expected to continue. This proposal also does not require early implementation of a domestic emissions trading program in either the U.S. or Russia.

The number of firms that would be willing to make such contracts, and the prices they would be willing to pay for contractual promises to deliver allowances in the future, will depend critically on how certain and reliable such promises appear to be. While establishing a favorable investment climate in Russia or other potential seller countries is a much broader task, specific steps towards developing confidence in government sales of GHG allowances could taken by entering the proposed framework trading agreement. Other confidence-building steps forward specific to GHG emissions trading are suggested below.

Russian government representatives who work on climate change have already indicated great interest in an early trading arrangement and willingness to dedicate the funds from early trading as proposed here. Given their limited authority, however, we would have to pursue this issue at much higher levels of their government. Discussions on this type of arrangement have not yet begun with the Ukraine.

<u>Basic Elements of the Framework Agreement</u>

The U.S. and the Russian Federation would negotiate an inter-governmental agreement, memorandum of understanding, or other appropriate instrument that would commit the two countries to an early trading arrangement on the basis of the principles described above. (Other countries could be included in the same agreement, or there could be a number of parallel bilateral agreements.) The principal elements would provide for:

- Contracts between buyer-side private sector legal entities and seller country governments (or legal entities empowered by their government) for the future delivery of tradeable units, with partial payment up front and full payment on delivery after seller ratification;

- Seller country agreement to dedicate the proceeds of early trading to development of the needed measurement and reporting infrastructure and to investment in specific emissions-reducing modernization and efficiency projects and forest projects to increase absorption by sinks;

- Buyer country agreement to recognize tradeable allowances purchased by and delivered to its private sector entities as valid for use against domestic obligations if and when Kyoto is ratified.

What Would the Russian Federation (or Other Seller Governments) Need To Do To Advance This Proposal?

The Russian Federation (or other seller country) would need to develop the legal structure and administrative arrangements to enable itself to enter legally binding contracts to deliver tradeable allowances to purchasers at a set point in the future. This would include giving a competent ministry the obligation to carry out such transactions and to set up and maintain a national registry to account for sales of allowances, including those that have been obligated, and actually delivered, to purchasers. In addition, the Russian Federation (or other seller country) would need to establish the legal and administrative framework to dedicate funds received to needed monitoring and reporting enhancements, as well as to emission abatement and absorption projects.

A firm legal basis in these areas would increase certainty for foreign investors and, therefore, increase the value of early tradeable units. This may require issuance of a new Russian Federation government directive and possibly passage of legislation.

What Would the United States Need To Do To Advance This Proposal?

The U.S. government would need (1) to set up a domestic means for tracking early trades and (2) to provide assurances that allowances purchased by U.S. private entities from Russia (or other sellers) will be accepted to meet domestic obligations in the event that the Kyoto Protocol is ratified. In addition, it would be essential to continue providing potential seller countries with limited technical assistance through USAID, EPA, and DOE.

How Would This Arrangement Be Perceived in the United States?

Since the early trading arrangement would be on a purely voluntary basis, much of the U.S. private sector should be supportive. Broad issues of uncertainty about doing business in Russia would discourage investor interest and lead to significant price discounting of tradeable allowances. Low prices may attract investors and entities wishing to hedge against domestic restrictions in the future.

Opponents of Kyoto in the private sector or in Congress may try to classify this activity as premature or "back door" implementation. However, because U.S. private sector participation would be voluntary and without governmental expenditures (beyond limited technical assistance), such a characterization is unlikely to take hold.

Some U.S. environmentalists would likely view this arrangement as a positive step. A Russian commitment to dedicate the funds to needed monitoring and reporting infrastructure, as well as to concrete emissions-reducing projects, would go a long way to meet their concerns about "hot air trading."

How Would This Arrangement be Perceived by the European Union?

One of the European Union's objections to trading with Russia is concern over "hot air." Russian representatives have already proposed to dedication the funds from early trading as described above, in part to diffuse the "hot air" issue. As with U.S. environmentalists, a Russian commitment to dedicate the funds to green purposes as described above would go a long way to meet their concerns. Maintaining an open, non-exclusive arrangement would also reduce tensions with the EU.

How Would This Arrangement be Perceived by Russia?

Russian government representatives working on trading have expressed great interest in an early trading arrangement. Their first thought and clear preference is for a U.S. government-funded purchase. It will take some work to familiarize them with the arrangement suggested here, in which the U.S. government role is to facilitate private sector investment. More important, it will take very high-level interaction to gain sufficient attention and commitment from levels of the Russian government who are capable of taking the actions needed on their side to make this arrangement viable.

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January 20, 1999

MEMORANDUM FOR SUSAN WICKWIRE, OFFICE OF GLOBAL CHANGE
STATE DEPARTMENT

FROM: JEFF FRANKEL JF

SUBJECT: State Department's Climate Change Talking Points for Environment Committee of Gore-Primakov Commission

We offer the following three-part suggestion.

1) Remove from main set of talking points the three page-2 bullets that begin as follows: "We noted..." "Russia could use a portion of these proceeds..." And "Proceeds could also go toward..." Their use might exceed the interagency consensus at this time.

2) Insert in their place a bullet along the lines: "To allay concerns from some [i.e., some Europeans and environmentalists] that the trading system might not produce genuine environmental benefits, we think that some further step may be needed on the Russian side, simultaneous with the revenue transfer. We would like to hear any ideas the Russian side might have on this score."

3) Then, if and only if the Russians sound responsive and ask what ideas **we** have on that score, we respond as follows:

- One possibility is using the revenue for environmental purposes. (The three omitted bullet points would come in here.)

- Further, I would suggest a second possibility that could be explored at this point, the idea explained in my memo of 1/19: A high-level US-Russia deal would offer them whatever private-sector permit-futures money we can put together *in exchange, not for any commitment about how they will spend the money, but for a commitment that part of their IMF-negotiated budget plan will include a reduction in their fossil-fuel subsidies (*with the budgetary savings earmarked for such social priorities as paying pension arrears*)*.

It might be premature to raise either of these possibilities with the Russians this week. In that case, our people would not go beyond item (2).

cc: Melinda Kimble, State
Monica Eppinger, State

~~Confidential,~~ close hold. Deliberative document.
For possible use in international negotiations

January 18, 1999

To: Frank Loy, UnderSecretary of State
Melinda Kimble, Acting Assistant Secretary
Richard B. , OVP

From : Jeff Frankel, Member, CEA

Re: Russia and Greenhouse Gas Emissions

Each of you late last week expressed some interest in a memo on an "outside-the-box" proposal for addressing Russian participation in international GHG reductions.

First a restatement of the "inside-the-box" approach, and its problems.

The Europeans and others oppose unrestricted trading on the grounds of concerns about Russian "hot air." [There are really three concerns: (1) an aversion to trade (which we regard as unreasonable), (2) a view that the Russians received too large an allocation at Kyoto (to which our response is that this objection comes too late), and (3) a fear that the Russians might abuse the trading system by selling more than they are entitled to (it is easier to see the point here).] We need an initiative with the Russians that will allay some of the European concerns.

Some agencies (EPA...) have proposed that we take advantage of whatever willingness there might be currently in the US private sector to buy emission permits speculatively (e.g., forward contracts), by bundling together whatever money that produces and offering it to the Russians in exchange for a commitment on their part to spend the money on monitoring and abatement projects. The aim is to produce tangible green benefits to impress the Europeans.

If this proposal is meant to be a complete approach to the problem at hand, its drawbacks are legion.
(1) Private companies will not pay much for permits, because of the uncertainties regarding the ratification and implementation of Kyoto, and regarding the legitimacy of Russian permits.
(2) It is unlikely to be feasible to enhance the pot with USG funds, due both to budget considerations and to "back-door implementation" charges.
(3) The Russians might not be willing to sell their permits at the steep discount that would be necessary. Recent history has made Moscow very sensitive to domestic political charges of selling the national patrimony at a pittance.
(4) A foreign insistence that they spend the money on specific purposes constitutes an additional restriction tacked on to what they were promised in the Kyoto Protocol. They are unlikely to be receptive.
(5) If the Russians were to take the money, and promise to use it for environmental purposes, it is

unlikely to produce much result. Even in the best of countries, the rule is fungibility, not additionality; i.e., the government could spend the US money on environmental and energy projects that were going to happen anyway, in place of other money. In Russia, where pensioners and soldiers are starving because the government doesn't have the funds to pay them, any new funds will surely end up being diverted. That the money would be diverted to other government programs is the optimistic view. The pessimistic view, many will say, is that the money would be diverted to Swiss bank accounts.
(6) If the environmental benefits are not real, the Europeans will be unimpressed, and the future credibility of the trading system will have been undermined rather than bolstered.
(7) Outside of the environmental ministry, the Russian leadership is overwhelmingly (and understandably) preoccupied with their financial crisis.

Simple variations on the proposal are unlikely to work. The inescapable quandary is that it is difficult to squeeze non-negligible environmental benefits out of negligible financial resources.

The Russians are under intense pressure from the IMF and the rest of the international financial community to improve their budget drastically, by either raising taxes or cutting spending. The outside-the-box proposal is for a high-level US-Russia deal in which they are offered whatever private-sector permit-futures money we can put together *in exchange, not for any commitment about how they will spend the money, but for a commitment that part of their IMF-negotiated budget plan will include a reduction in national subsidies of fossil fuels.* (The eventual long-run goal would be elimination of such subsidies.) The considerable budgetary savings could be explicitly and publicly earmarked for such social priorities as paying pension arrears, in order to help diffuse popular resistance to the loss of fuel subsidies. At the same time, the increase in the price of fossil fuels would produce more GHG reduction than would any promises of green earmarking. Environmentalism should be easier when it saves money, than when it costs money.