Climate Change and Sustainable Development Committee Newsletter

Vol. 6, No. 2 April 2003

INTRODUCTION

Tom Kerr
Amy Royden
Newsletter Co-Editors

Welcome to the Spring 2003 edition of the Newsletter. For many years, the mainstream view in the business community on climate change was that it is a long-term issue that will take years to sort out and, therefore, companies need not take a serious look at how it might affect them. However, the reality is that there are an increasing number of climate change developments at the state, federal, and international levels that directly affect companies *today*. Companies are responding to these developments in a variety of ways, including voluntary greenhouse gas emissions (GHG) reporting, emissions trading, or strategic planning to reduce their carbon risk exposure.

With this issue, we are continuing our tradition of providing you with practical information about the latest climate change developments. This issue will focus on international developments, and includes an update on Kyoto Protocol ratification, information on the new greenhouse gas (GHG) accounting standard under development by the International Organization for Standardization (ISO), as well as reports on efforts underway in the European Union and Canada to implement their Kyoto obligations. Future issues of the Newsletter will focus on climate initiatives in U.S. states and voluntary company activities to track, reduce, report and otherwise mitigate their “carbon risk” exposure.

KYOTO PROTOCOL UPDATES

Donald Goldberg
Center for International Environmental Law

The CDM Executive Board has held eight meetings to continue to develop rules for the Clean Development Mechanism (CDM). Issues currently under discussions include accreditation of operational entities, methodologies for baselines and monitoring, and registration of projects. A particularly contentious issue has been the definition of additionality. Environmentalists claim that credited projects must be additional; that is, free-rider credits to projects that would have happened anyway should be avoided. Many businesses, however, and some countries have expressed an opposing view. They believe credit should be available as long as emissions with the project are lower than emissions would be without the project. The *why* of the project is irrelevant, they argue.

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Amy Royden and Tom Kerr, Editors

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Chicago, IL 60611.

No new text has been developed on sinks since Marrakesh, though there have been workshops on technical issues. Some key issues will be taken up at the next subsidiary body meeting in June, however, and are expected to be resolved at COP9. To be decided are the rule for permanence and definitions of afforestation and reforestation in the CDM. Two competing approaches for resolving the permanence issue are ton year accounting, which would assign a certain amount of credit for each year that the sink remains standing, and "Temporary CERs (Certified Emissions Reductions)," which would create credits that expire after a given time and must be replaced either by a permanent or new temporary CER. Some Parties may seek sinks rules for baselines, additionality, leakage, and environmental and socio-economic criteria, but others likely will oppose any refinement of existing rules.

Entry into force still hinges on Russia. As of March, 106 states, representing 43.9 percent of Annex I emissions, had ratified or acceded to the Protocol. The Protocol has a dual threshold for entry into force. A minimum of 55 countries must ratify or accede to the Protocol, and ratifying and acceding Parties must represent at least 55 percent of Annex I emissions. At this point, ratification by the Russian Federation would meet all criteria for entry into force. Russia announced its intention to ratify at last year's World Summit on Sustainable Development, but has not yet done so.

COP8 REPORT: ADDRESSING CLIMATE CHANGE MAY DELAY OZONE LAYER RECOVERY

Pamela Wexler

At the Eighth Meeting of the Parties to the U.N. Framework Convention on Climate

Change (UNFCCC) (COP8) in New Delhi, India in October 2002, the Parties requested the Intergovernmental Panel on Climate Change (IPCC), in consultation with the Montreal Protocol’s Technical Economic and Assessment Panel (TEAP), to develop a special report on hydrofluorocarbons (HFCs). The Special Report, expected to be available in early 2005, is intended to improve decisionmaking about replacing ozone-depleting substances (ODSs) and ensure that such decisions promote the objectives of the Climate Convention, Kyoto Protocol and Montreal Protocol.

The Decision reflects increasing concern about the use of certain Kyoto gases – primarily HFCs, ammonia and carbon dioxide – as replacements for ODSs. HFCs, for instance, have allowed for the rapid phaseout of chlorofluorocarbons (CFCs) and halons in developed countries, and are still important to the safe and cost-effective phaseout of those ODSs in economies-in-transition and developing countries. UNFCCC Parties are anxious to stem steep projected increases of HFC emissions, while among Montreal Protocol decisionmakers there is concern that Kyoto restrictions on the use of HFCs could delay and increase the cost of the phaseout of CFCs where alternatives to ODSs do not exist.

Both Protocols share the concern that potential restrictions on HFCs creates business uncertainties and could force manufacturers to either prolong the use of ODSs, delaying ozone layer repair, or compromise performance with the potential for *increasing* energy use and associated emissions. The Special Report is expected to help countries and the private sector make fully informed decisions about ODS replacements, and to further assist countries to optimize their approaches to minimizing greenhouse gas emissions.

AMERICAN BAR ASSOCIATION
SECTION OF ENVIRONMENT,
ENERGY, AND RESOURCES

Calendar of Section Events

Roundtable on Biotechnology – Biopharming and the Biosafety Protocol
May 21, 2003
St. Louis, Missouri

Wetlands Law and Regulation
May 28-30, 2003
Washington, D.C.
(Co-sponsored with ALI-ABA, for information call 800/253-6397)

ABA Annual Meeting
August 7-12, 2003
San Francisco, California

Conference on Federal Lands and Natural Resources Law
September 17-19, 2003
Seattle, Washington
(Co-sponsored with ALI-ABA, for information call 800/253-6397)

11th Section Fall Meeting
October 8-12, 2003
Washington, D.C.

For more information, see the Section Web site at http://www.abanet.org/environ or contact the Section at 312/988-5724.

SECTION OF
ENVIRONMENT
ENERGY AND RESOURCES

ISO BEGINS DEVELOPING NEW GHG ACCOUNTING STANDARD

Who? The International Organization for Standardization (ISO) is a non-governmental network of national standards institutes from 145 countries working in partnership with international organizations, governments, industry, business and consumer representatives. The ISO 9000 and ISO 14000 families are among ISO's most widely known and successful standards; ISO 9000 has become an international reference for quality requirements in business to business dealings, and ISO 14000 is on track to achieve at least as much, if not more, in helping organizations to meet their environmental challenges.

What? ISO's Technical Committee 207 (TC 207) has begun developing a new standard divided in three parts, titled:

- ISO 14064 Greenhouse gases - Part 1: Specification for the quantification, monitoring and reporting of entity emissions and removals

- ISO 14064 Greenhouse gases – Part 2: Specification for thequantification, monitoring and reporting of project emissions and removals

- ISO 14064 Greenhouse gases – Part 3: Specification and guidance for validation, registration, verification and certification.

Currently, there are three draft documents, one that lays out a potential standard for greenhouse gas emissions at the entity, one for project levels, and one that covers validation, registration, verification and certification of greenhouse gas reporting.

Why? ISO initiated this process in response to the proliferation of voluntary and mandatory climate change reporting initiatives. ISO hopes that a new "regime neutral" ISO GHG standard will promote integrity in greenhouse gas measurement and reporting, facilitate trade in greenhouse gas credits and enable organizations to more effectively manage risk associated with their climate change assets or liabilities.

When? ISO observers predict that the new standard will be finalized by 2005. The TC 207 met March 10-13, 2003 in Malaysia to review country comments on draft documents. The main accomplishments of the meeting were: 1) the determination of the structure of a new set of documents, 2) preparation of new working drafts of the entity and validation/ verification portions of the standard, and 3) formal acknowledgement of the existing World Resources Institute/World Business Council on Sustainable Development (WRI/WBCSD) GHG Protocol as formal guidance for the ISO standard. The next ISO meeting on this standard will take place June 30-July 4 in Indonesia. The goal of the Indonesia meeting is to develop a first committee draft of the entity portion of the standard; the project and validation/verification portions may not be ready by that time.

What can I do to get involved? Join the U.S. Technical Advisory Group (U.S. TAG), which is part of the American National Standards Institute (ANSI), the official U.S. ISO representative organization. To join the U.S. TAG, contact Tom Kerr at kerr.tom@epa.gov for more information.

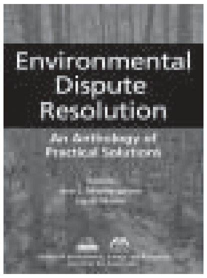
ABA Section of Environment, Energy, and resources

11th Section Fall Meeting
Washington, D.C.
October 8-12, 2003

Save the Date!

New from ABA Publishing and The Section of Environment, Energy, and Resources

Environmental Dispute Resolution: An Anthology of Practical Solutions
Ann L. MacNaughton and Jay G. Martin, editors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Summary of Contents

- Environmental Conflict Management and Dispute Resolution: A Framework for Analysis
- Moving Beyond the Familiar Rules: The Challenges of Alternative Dispute Resolution
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- Mediating with an Environmental Enforcement Agency
- Effective Settlement Strategies in Public Disputes
- Public Access to EDR Processes: US and UK Trends Toward a Common Approach
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- Resolving Superfund Cost Recovery Disputes Outside the Courtroom
- Effective Settlement Advocacy in Environmental Insurance Coverage Disputes
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EU DIRECTIVE ON EMISSION ALLOWANCES TRADING (PROPOSAL)

Rutger de Witt Wijnen

Introduction

Only a few things can be as frustrating as writing an article on greenhouse gas emissions trading these days. There are new developments almost on a daily basis. By the time you have finished your draft article, not to mention at the time of publication, you will discover to your dismay that some conclusions or predictions are already history. The only consistency in the area of greenhouse gas emissions trading over the last few years has come from Washington, D.C.: a consistent and deafening silence. Keeping this caveat in mind, I will give a brief update on the status of the proposal for a directive establishing the framework for an EU-wide system of greenhouse gas emission allowance trading (the EU Directive), highlighting some key issues in the implementation process. See http://register.consilium.eu.int/pdf/en/02/st15/st15792en02.pdf.

Relevance for U.S. Companies

The EU Directive is not only relevant for European companies, but also for U.S. companies. First, for U.S. companies with operations in Europe which fall under the scope of the EU Directive, the Directive will impact the way such operations do business. It may also have an impact on their consolidated annual accounts, which will have to take into consideration potential liabilities and positions in Allowances (as defined below). Secondly, the EU Directive will be relevant for U.S. companies considering acquiring a business in Europe. Compliance with the EU Directive will become an important part of the due diligence process in affected industries.

The EU Directive

For an excellent summary of the EU Directive, I refer to the contribution by Mary Anne Sullivan and Jacqueline Mailly in the ABA Section of Environment, Energy, and Resources' Climate Change and Sustainable Development Committee Newsletter of January 2002. With the risk of some repetition, I will first identify a few highlights of the EU Directive in the context of important topics that are currently being debated.

The system under the EU Directive will apply to coke ovens, mineral oil refineries, combustion installations with a rated thermal input exceeding 20MW (except hazardous or municipal waste installations), production and processing of ferrous metals, the mineral industry and production of paper, board and pulp from timber. Certain threshold values apply. (For installations producing pig iron or steel: 2.5 tons/hour; for production of cement clinker in rotary kilns: 500 tons/day or lime in rotary kilns or in other furnaces 50 tons/day; for the manufacture of glass and glass fiber: a melting capacity of 20 tons/day; for the manufacture of ceramic products by firing: 75 tons/day, and/or with a kiln capacity exceeding 4 m^3 and with a setting density per kiln exceeding 300 kg/m^3; and for production of paper and board: 20 tons/day.)

Initially, only these installations and activties will be covered by the EU Directive. Member States may apply to the EU Commission to exclude certain installations and activities until Dec. 31, 2007. However, Member States may, subject to approval by the EU Commission, apply emissions allowance trading to installations carrying out the activities listed above below the capacity limits referred to in Annex I of the EU Directive. Also, as from 2008 Member States may apply emission allowance trading to activities, installations and greenhouse gasses which are not listed in Annex I to the EU Directive, subject to the approval of the EU Commission.

The EU Directive is limited to the emission of carbon dioxide, but is likely to be extended to other greenhouse gases in the future. It is unclear when such extension would occur. There are indications that the European Parliament will propose an amendment to that effect so that other greenhouse gases may already be covered in the initial compliance period which runs from 2005 to 2008.

Under the EU Directive, Member States are obligated to establish absolute limits on the emissions of carbon dioxide gases from the installations covered (Installations). Operators of Installations have to obtain a greenhouse gas emissions permit and need emission allowances. Allowances will be allocated by the respective Member States according to a national allocation plan. The EU Commission shall ultimately by Dec. 31, 2003, develop guidelines on the implementation of the criteria for the national allocation plans, which are annexed to the EU Directive.

Main Features of the EU Directive

Allowance

The EU Directive defines an allowance as “the allowance to emit one tonne of carbon dioxide equivalent during a specified period” (Allowance). This definition closely resembles the definitions of the various units under the Kyoto Protocol so as to facilitate a link between the two schemes. Allowances will be allocated to operators of Installations pursuant to a national allocation plan.

Trading of Allowances

Allowances can be transferred (a) between persons within the European Community and, (b) between persons within the European Community and persons in countries listed in Annex B to the Kyoto Protocol which have ratified the protocol, provided, however, that such Annex B countries have entered into an agreement with the Community on the mutual recognition of their allowance trading schemes. Any person may hold Allowances. Under the EU Directive it seems to be irrelevant whether or not the Kyoto Protocol enters into force, as long as it has been ratified by the relevant Annex B country. Although this provision appears to be primarily aimed at linking the EU and the Kyoto community, it also opens the door to fungibility of Allowances with allowances under certain national trading schemes, such as in Canada.

Cancellation of Allowances

Each year the operator of an Installation has to surrender a number of Allowances equal to the total emissions from such Installation during the preceding year. These Allowances are subsequently cancelled. Allowances will also be cancelled at any time at the request of the person holding them. This provision allows third parties, such as environmental groups, to remove Allowances from the market thereby limiting the total permitted output of greenhouse gasses.

Validity of Allowances

Allowances shall be valid for the relevant compliance period. The first compliance period runs from 2005 until 2008. Thereafter, each five-year period shall be a compliance period. Any excess Allowances, *i.e.*, any Allowances not surrendered to offset emissions from an Installation in a compliance period, will be replaced by Allowances valid for the new compliance period. This provision allows banking of Allowances.

Registries/Transaction Log

Each Member State shall establish a registry containing separate accounts to record the Allowances held by each person. The registries shall be accessible to the public. Member States may, but are not obliged to, maintain their registries in a consolidated system. The Commission will adopt a regulation for a standardized system of registries in the form of standardized electronic databases, containing common data elements to track the issue, holding, transfer and cancellation of Allowances. This regulation is also to ensure that there are no transfers incompatible with obligations under the Kyoto Protocol.

A Central Administrator will maintain an independent transaction log. Each transaction in national registries shall be automatically checked to ensure that there are no irregularities. If irregularities come up, the Central Administrator shall inform the relevant Member State(s) who shall not register the transaction.

Linking

It is the intent that links will be made to other emission trading schemes, such as Emissions Trading under the Kyoto Protocol. First of all, through agreements concluded with third countries listed in Annex B to the Kyoto Protocol. Secondly by recognizing emission credits from project-based mechanisms in accordance with a directive which is to enter into force simultaneously with the EU Directive, *i.e.* 2005. This directive will be primarily focussed on recognizing credits derived from Joint Implementation (JI) and Clean Development Mechanism (CDM) projects.

Timeframe

The first step towards adoption was taken by the political agreement on the EU Directive in the European Council on Dec. 9, 2002. As the next step, the proposal for the EU Directive needs to be approved by the European Parliament. The Parliament is expected to vote in July/September of this year. If no amendments are made by the European Parliament, the EU Directive will be adopted by the end of this summer. However, if amendments are adopted by the European Parliament, which is currently considered likely to occur, the proposal will go back to the European Council. Should the Council not approve of the amendments, a Conciliation Committee will be established with the mission to approve of a joint text within six weeks. In this scenario the adoption of the EU Directive by the end of this year looks more probable.

Once the EU Directive is final and has entered into force, the actual implementation process will begin as a directive is an instruction to the EU Member States to implement legislation in their respective jurisdictions. The EU Directive itself does not establish a trading scheme; it only provides a framework for the Member States to be filled in with national legislation.

The EU Directive does provide a timeframe for implementation: Member States are to bring into force the laws, regulations and administrative provisions necessary to comply with the EU Directive by Dec. 31, 2003 at the latest. This date may be problematic, if the EU Directive is not adopted ultimately by the end of the summer so this date may change during the current adoption process. Irrespective of what the final date will be, it is clear that the EU Directive will provide for an ambitious time frame as the prohibition to operate a facility covered by the EU Directive without a permit takes effect on Jan. 1, 2005. Also, Allowances will be allocated for the first period of three years which begins on Jan. 1, 2005.

Important Topics

Even though the EU Directive is still before the European Parliament, intense debates are currently taking place regarding various implementation issues.

Kyoto and EU Registries?

There is an important, but quite technical, debate going on whether the registries to be established pursuant to the Kyoto Protocol may be the same as the registries to be established pursuant to the EU Directive. It would go too far to describe this debate in detail in this contribution, but it is important to note that the issue of registries is a typical example of how important and complicated the details of establishing successful cross-border emissions trading schemes will be. Without doubt, the correct registration of ownership and transfer of Allowances and the Kyoto units will be key to the success of both schemes.

Compliance with the Kyoto Protocol

The foregoing expectation is consistent with the instruction in the EU Directive that a regulation by the Commission will have to address compliance with obligations under the Kyoto Protocol. This requirement might lead to unforeseen consequences which may not be compatible with the intent to create normal market conditions. For instance, each party included in Annex I to the UN Framework Convention on Climate Change (Annex I Party), which includes each EU Member States, is obliged to keep a commitment period reserve in its national registry which should not drop below 90 percent of such party's assigned amount. If a legal entity with an account in Member Country A wants to transfer an amount of Allowances to an account in another jurisdiction as a result of which the commitment period reserve of A would drop below 90 percent of its assigned amounts, this transfer is incompatible with A's obligations under the Kyoto Protocol. Consequently, the Central Administrator will inform the EU registry in country A that the transfer cannot be made. Neither seller, nor buyer in this trade of Allowances will be amused.

Laundering CDM and JI and Credits

Credits resulting from CDM or JI projects, Certified Emisisons Reductions (CERs) and Emissions Reductions Units (ERUs) respectively, have limitations on their bankability, because CERs and ERUs held in a national (Kyoto) register may be carried over to a subsequent commitment period in each case up to a maximum of 2.5 percent of the assigned amount of the relevant Annex I Party. Allowances do not have these limitations. The EU trading scheme should not become the laundry machine for soon-to-be-expiring CERs and ERUs. Therefore, the modalities to be adopted by the EU Parliament and the Council regarding the recognition of emission credits from project-based mechanisms will undoubtedly include some form of limitation on such recognition.

Old and New Europe

Recently some so-called EU accession countries, which will join the EU within the next few years, have expressed concerns on the implications of the EU Directive on their national industries. By the time these accession countries become EU Member States, the EU Directive will most likely have become effective and will, therefore, also apply to the new EU entrants. I expect there will be some further debate if and to what extent the application of the EU Directive can be delayed or watered down for an interim period for the accession countries.

Concluding Remarks

Although the EU Directive has not yet entered into force, the first future trade of Allowances has already taken place. Shell Trading, based in London, and Nuon, a Dutch energy company, announced on February 27 of this year the completion of the first ever future trade of Allowances to be allocated under the EU Emissions Trading Scheme. More trades are to be expected in the near future well before the EU Directive and the national implementation laws will have entered into force. The International Emissions Trading Association (www.ieta.org) has taken the initiative to draft standard agreements for trading under the EU Trading Scheme. The first draft, an Allowances Emission Trading Master Agreement, is expected to be published within the next few months. There appears to be an appetite in the European market to commence trading. Experience gained in this market will undoubtedly be of great help to the legislators in the various EU Member States in working out the devilish details of quite a complex and novel way of curbing greenhouse gas emissions, because there is little doubt in my mind that the EU Directive will – eventually – enter into force.

Rutger de Witt Wijnen is a partner in the New York office of the Dutch law firm De Brauw Blackstone Westbroek (www.debrauw.com). He thanks his colleague Sija van Mourik for her valuable suggestions.

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Amy Royden (aroyden@4cleanair.org) or
Tom Kerr (kerr.tom@epa.gov).

CANADA RATIFIES KYOTO AND TAKES FIRST STEPS TO IMPLEMENT CLIMATE CHANGE PLAN

Elisabeth DeMarco

On Dec. 17, 2002, Canada ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change (the Kyoto Protocol) following symbolic ratification votes from the House of Commons and the Senate. Approval from these legislative branches of government was sought only to demonstrate public support for ratification and is not required under Canadian law as treaty-making power resides exclusively in the executive branch of the Canadian government.

Ratification was based on the Canadian government's *Climate Change Plan for Canada* (the "Implementation Plan"), that was released in final form on Nov. 21, 2002. The Implementation Plan includes a combination of current, proposed and future actions directed at seven main sectors in order to address the 240 million metric tons (MT) of carbon dioxide equivalent that Canada must reduce under the Kyoto Protocol. The central features of the Implementation Plan include:

- the establishment of a domestic emissions trading system targeting the below-mentioned large industrial emitters (LIEs)
- the purchase of international emission reductions
- maximizing emissions reduced by forestry and agricultural sinks
- targeted regulatory measures directed primarily at the transportation, municipal and housing and building sectors
- emission reduction objectives for individual Canadians
- establishment of incentives for renewable energy, small and medium enterprise energy efficiency, clean fossil fuel, and CO_2 capture and sequestration infrastructure
- a partnership fund to share costs of

emission reductions with provincial and municipal governments.

Highlights of the Proposed Domestic Emissions Trading System

The proposed emissions trading system will take the form of a hybrid system requiring a total of nearly 100 MT of CO_2 emission reductions from certain large industrial emitters and allowing those emitters to use to domestic emission offsets and international emission reductions to meet those commitments. Currently sectors that will be covered in the mandatory domestic emissions trading system include: thermal electricity generation (coal, oil and gas); oil and gas (upstream extraction, oil and gas pipelines, gas utilities, petroleum refining); mining; pulp and paper production; chemical production (including fertilizers); iron and steel production, smelting and refining; cement and lime production; and glass and glass container production.

The sector-based emission reduction commitments will be founded on sector covenants with government that are backed by regulatory or financial measures. The Canadian government, through Natural Resources Canada, is currently in the process of negotiating sector-wide emission intensity factors and is scheduled to release a model sector covenant for negotiation purposes in spring 2003. Within targeted sectors, each facility will receive an allocation of allowances on the basis of its sector's emissions intensity factor, projected output and growth. Capped facilities will also have access to certain approved domestic offsets (proposed to come from agriculture, forestry, and possibly, landfill gas) and international emission reductions in order to meet their emission reduction requirements.

In response to industry concerns about international competitiveness, and in particular competition with U.S. market participants, the federal government has also committed to limit both the quantity and price of emission reductions for capped industrial sectors. Specifically, the government has indicated that it will ensure that Canadian companies will not have to pay more than $15 (Cdn)/ton CO_2 to meet their emission reduction targets. If the price of CO_2 allowances and offsets exceeds this limit, the government is likely to make up the shortfall through international credit purchases. The government has also committed that the oil and gas sector emission intensity target will be set at a level that will require no more than a 15 percent reduction from business as usual emission levels in 2010. Most recently, during the negotiation of the sector emission intensity targets, the government indicated that the $15/ton pricing guarantee may only apply if a company is "prudent" in its greenhouse gas mitigation strategy. This statement has led to considerable industry uncertainty regarding the conditions, nature and extent of the government's pricing and quantity guarantee.

There are still a large number of details to be determined before the proposed domestic emissions trading system is implemented in the current 2005 to 2006 time frame. One of the most difficult issues that the Canadian government may have to grapple with will be potential conflicts between Canadian NAFTA obligations and Canadian Kyoto obligations resulting from the exclusion of U.S. emission reductions from the Canadian emission trading market place.

For further information on the Canadian Implementation Plan please do not hesitate to contact Elisabeth (Lisa) DeMarco at 416/203-4431 or elisabeth.demarco@ tor.macleoddixon.com.

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