

Compliance, enforcement and the LCA Text

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1. INTRODUCTION AND SCOPE

- 1.1 In this briefing paper (the “Paper”), we set out our views on the following questions:
- 1.1.1 What is a compliance / enforcement mechanism? What is its purpose and why is it important?
 - 1.1.2 Where would be the most appropriate place in the LCA text for such a mechanism (which deals with finance and mitigation by developed country parties only) to be inserted?
 - 1.1.3 Please design (with suggested drafting) a mechanism (broadly based on the Kyoto Protocol mechanism) which includes facilitative compliance steps along with a more penalty based system. The enforcement side of it should include sanctions such as financial penalties commensurate with the level of breach by a developed country party of its finance delivery obligations and/or its mitigation targets. It should also give the option to the ‘Compliance Committee’ to deem any excess emissions in a particular designated period as having been emitted in a subsequent period (similar to the EUETS rules for Phase III).
- 1.2 Our analysis in respect of the questions referred to in paragraphs 1.1.2 and 1.1.3 are subject to a number of assumptions which are set out in further detail in section 3 of this Paper.

2. WHAT IS A COMPLIANCE / ENFORCEMENT MECHANISM? WHAT IS ITS PURPOSE AND WHY IS IT IMPORTANT?

Introduction and scope of this section

- 2.1 For the purposes of the Paper, we have concentrated on the role and function of compliance mechanisms in emission trading regimes (“ETR”). In particular, we have considered types of compliance and enforcement mechanisms which can be found in various ETRs, their purpose in ensuring the effectiveness of such regimes and their importance in preventing the “sleeping treaty” effect.
- 2.2 We believe, however, that the underlying policy issues as to the need for compliance mechanisms can be applied more widely.
- 2.3 For ETR to operate efficiently and to meet environmental targets, strong compliance and enforcement systems are a pre-requisite. Compliance will analyse whether rules are being respected. Where non-compliance is revealed, an enforcement mechanism will be triggered.

- 2.4 Indeed, the Kyoto Protocol and other regional ETRs rely heavily on economic tools to achieve compliance and enforcement of the obligations stemming therefrom. The Kyoto Protocol, in this sense, departed from the traditional international treaty enforcement mechanism which referred disputes over the interpretation or implementation of its provisions to *ad hoc* arbitration tribunals or the International Court of Justice. Inspired by the 1992 Montreal Protocol, the Kyoto Protocol brings about the most “forward-thinking” compliance and enforcement mechanism¹ for international treaties.

Compliance and Enforcement mechanisms explained

Compliance

- 2.5 Compliance involves continuously assessing whether participants in an ETR are respecting their obligations. This can be broken down into two key steps: monitoring emissions and accounting for their trades of units.
- 2.6 The basis of ETRs consists of measuring the level of actual emissions of participants. This relies on technology being in place which allows for reliable and consistent measurement of emissions. Detailed information of participants’ actual emissions is reported to the regulatory authority. This is known as “monitoring”.
- 2.7 After a regulatory authority has information of the actual emissions of the participants, it needs to keep track of each participant’s trades in order to detect excess emissions in relation to its allowance and other types of non-compliance. Keeping track of emissions and trades for the purpose of assessing compliance is known as “accounting”².
- 2.8 ETRs employ different techniques to monitor actual emissions and to account for excesses, which range from self-reporting, to on-site inspections, to registries. For example, the SO₂ and RECLAIM programmes in the US rely heavily on self-reporting by the participants to the regulatory authority. In order to avoid inconsistencies with the measurement of emissions, both systems impose stringent technological requirements on the participants³. Transmission of information to the regulatory authority is fully automated and audited at the end of every year. On-site inspections may follow after the data reported has been examined and suspected incidences of non-compliance are noted.
- 2.9 Another monitoring technique is to place the responsibility on the participants. For example, participants in the Dutch NO_x trading programme are responsible for drafting their own monitoring protocol⁴, which is approved by the authority. Participants have to monitor their emissions in accordance with their approved protocol and submit an annual report to the authority. This report is then analysed for non-compliance.
- 2.10 Under the Kyoto Protocol ETR, participants have to submit an annual report and a national inventory in accordance with the UNFCCC reporting guidelines. The reports are subject to in-depth review. The facilitative branch of the Compliance Committee provides “early warning signals” of potential non-compliance with emissions targets, methodological and reporting commitments relating to greenhouse gas inventories and commitments on reporting supplementary information in a party’s annual inventory. The preventative technique it employs

¹ Malijean-Dubois (2007) “Les enjeux du contrôle international du respect des engagements”.

² Anderson (2003), “Kyoto Protocol accounting and domestic and regional trading regimes” cited in Peterson (2003) “Monitoring, Accounting and Enforcement in Emissions Trading Regimes”, presented at the OECD Global Forum on Sustainable Development: Emissions Trading.

³ Peterson (2003) “Monitoring, Accounting and Enforcement in Emissions Trading Regimes”.

⁴ Such a protocol is to set out the monitoring and reporting requirements for each installation.

by providing advice and facilitation to parties in implementing the Kyoto Protocol results in preventing the need for full enforcement action.

- 2.11 Accounting of emissions trades is normally done by recourse to registries. All three of the above ETRs, and the European Union Emissions Trading Scheme have registries⁵ where each emission unit trade is recorded. Registries work very much like a bank – they record trades, issuance and cancellations of tradable units. Each participant has a separate account which records the debit and credit of tradable units and the balance of its allowance. A transaction log which records transactions also verifies the eligibility of each participant in the trade and carries out checks for account inconsistencies.

Enforcement

- 2.12 Enforcement mechanisms are triggered where a breach of an obligation was detected through compliance tools. Successful enforcement programmes require a carefully construed set of sanctions for non-compliance⁶.
- 2.13 There are broadly four types of sanctions for non-compliance: (i) a public declaration of breach; (ii) a financial penalty per tonne of excess emissions; (iii) a deduction from the next year's allowance; and (iv) exclusion of the participant from the trading market.
- 2.14 The ETR under the Kyoto Protocol provides for, as one of its sanctions, a public declaration of breach. This sanction plays on the reputational effect of the participant. The enforcement branch of the Compliance Committee may also ask the concerned party to present a compliance action plan.
- 2.15 Most ETRs provide for a financial penalty for excess emissions. However, certain factors must be considered if this penalty is to have its desired deterrent effect (see 1.2 below). The level of the penalty needs to be higher than the allowance price. Otherwise it would be more economically viable for participants to acquire more allowances and accumulate financial penalties. One of the reasons for the success of the SO₂ ETR is that the penalty is 10 times higher than the allowance price. However, penalties should not be too high so as to trigger unnecessary insolvencies or deter participants from entering ETRs where these are voluntary.
- 2.16 Deduction from next year's allowance holdings is a type of enforcement mechanism which also ensures environmental integrity. The excess amount of emissions may be deducted from next year's allowance, thereby reducing it accordingly. The deduction sanction may be more severe where next year's allowance is reduced by, for example, 1.3 times⁷ the excess emissions. The NO_x ETR provides for a deduction of three times the excess emissions.

The purpose and importance of compliance and enforcement mechanisms

- 2.17 Compliance and enforcement mechanisms may be presented as having various purposes, but they all centre on the notion of ensuring the *effectiveness* of the ETR.
- 2.18 Regardless of how well the ETR is designed, if it lacks a compliance and enforcement mechanism, the ETR will mostly likely be ineffective. Participants would only comply with their obligations to the extent that it is in their interest. ETRs would have no "bite" as obligations are

⁵ Under the European Union Emissions Trading System, trades are recorded in the national Member State registry and reported to the EU Commission.

⁶ Tietenberg (2001) "The Tradeable Permits Approach to Protecting the Commons: What have we learned?".

⁷ Under the ETR of the Kyoto Protocol.

not legally enforced. They would risk being called “sleeping treaties” or “hot air” and be labelled as a waste of resources and time, with little practical benefit to the environment.

- 2.19 According to de Visscher, the effectiveness of a treaty’s provisions depends on whether they are able to determine the behaviour of those concerned⁸. This “determination” is achieved by the presence of compliance and enforcement mechanism in ETRs.
- 2.20 In this light, compliance and enforcement mechanisms have a dual role. First, they have a deterrent effect. Participants are discouraged from breaching the provisions of the ETR as this could bring about immediate and long-term economic consequences to their businesses. They are also discouraged by the negative effect on their reputations. In this way, they “determine”, and may serve to change, the behaviour of those concerned.
- 2.21 Second, and as a consequence of the above, they serve to promote the effectiveness of the rules and standards imposed by the ETR. This in turn guarantees the respect of the ETR’s environmental integrity and ensures that environmental, social and economic objectives are met. Indeed, the purpose of the compliance and enforcement mechanism of the Kyoto Protocol, for example, is to promote and guarantee the respect of the obligations arising therefrom.
- 2.22 It could also be said that in the environmental sphere, where remediation is rarely effective as the damage is done once the excess emissions penetrate the atmosphere, the early warning signals which can be received through compliance, and the deterrent effect of enforcement, are even more important in ensuring that the ETRs achieve their environmental objectives.

3. DESIGN AND POSITIONING OF A COMPLIANCE MECHANISM FOR THE LCA AGREEMENT

Assumptions and Scope for Sections 3-5 of this Paper

- 3.1 In sections 3-5 of this Paper, we propose a compliance mechanism for the LCA Agreement (the “**Agreement**”) and suggest an appropriate position for such a mechanism in the Agreement.
- 3.2 In drafting provisions for an agreement that is currently still under negotiations with multiple parties and possibilities as to the scope and legal status of that agreement, we have, by necessity, made a number of assumptions in order to develop the requested compliance mechanism. In particular, we are basing our response on the following:
- 3.3 We have considered the version of the Agreement dated 9 July as made available on the UNFCCC website⁹ and all references to the Agreement in our response should be construed as references to this draft of the Agreement. As the negotiations progress and further amendments are made to the Agreement, our suggested drafting may need to be adapted accordingly.
- 3.4 We have assumed that the Agreement will constitute a legally binding agreement and as such contains legally binding obligations upon its signatories.
- 3.5 The drafting of the Agreement contains numerous references to the Kyoto Protocol. We have therefore assumed that it is the negotiating parties’ intention that the Kyoto Protocol and the

⁸ De Visscher (1967) “Les effectivités du droit international public”, Paris, Pedone.

⁹ FCCC/AWGLCA/2010/8

institutions created pursuant to the same will continue to exist and have legal force as an instrument of international law even though some of the obligations it imposes upon its signatories will have fallen away in 2012 when the commitment period from 2008 – 2012 comes to an end.

- 3.6 As part of the question referred to at paragraph 1.1.3 above, reference is made to the possibility of giving the *“option to the ‘Compliance Committee’ to deem any excess emissions in a particular designated period as having been emitted in a subsequent period (similar to the EUETS rules for Phase III)”*.
- 3.7 However, there is no reference of commitment periods comparable to those under the Kyoto Protocol or the EU ETS in the Agreement. In addition, it is not clear whether market based tools such as emissions trading will be used in the implementation of the Agreement. Therefore, we have not been able to integrate this particular mechanism into our proposed compliance mechanism. Should the COP choose to include commitment periods and express reference to trading mechanism in the Agreement, our suggested compliance mechanism may need to be adapted accordingly.
- 3.8 This Paper offers no view on whether the desired compliance mechanism should apply only to the developed parties’ emission reduction obligations or to all obligations contained in the Agreement. As this has consequences for both the scope and positioning of the compliance mechanism within the Agreement, we have indicated alternative drafting for both possibilities.
- 3.9 Finally, we have tried to avoid the creation of unnecessary bureaucratic structures and additional committees under the Agreement. Therefore, taking into account our assumption set out at paragraph 3.5 above, the guiding principle of our suggested drafting has been to use the established institutions of the Convention and the Kyoto Protocol where possible. Where this has not been possible, we have created a corresponding institution or mechanism under the Agreement. This is most notably the case with the creation of the *“Meeting of the Parties to the Agreement”* so as to have a forum equivalent to the *“Meeting of the Parties to the Protocol”*, which has reporting and appeal functions in the context of the compliance mechanism.

4. POSITIONING OF THE COMPLIANCE MECHANISM WITHIN THE AGREEMENT

- 4.1 If the compliance mechanism is to relate to the emission reduction commitments in Chapter I of the Agreement, the most appropriate place for it might be a new section H of Chapter I as set out below, together with an Annex to Chapter I setting out the finer detail of the procedure.
- 4.2 Alternatively, if the compliance mechanism is to relate to the the various commitments and obligations by Parties a new Chapter X to the Agreement text might be considered with the text below as Chapter X and again an Annex to the Agreement setting out the detail of the procedure.

5. COMPLIANCE LANGUAGE FOR THE AGREEMENT:

- 5.1 For the operative wording in the body of the Agreement, it is proposed that the following language be included at either of the places above:

“decides to

Establish effective procedures and mechanisms to determine and to address cases of non-compliance with [Chapter I of this Agreement] OR [the provisions of this Agreement]¹⁰ as set out in Annex [XXX] to this Agreement, including through the development of a non-exhaustive list of [binding] consequences, taking into account the cause, type, degree and frequency of non-compliance. [Any procedures and mechanisms under this Article entailing binding consequences shall be adopted by means of an amendment to this Agreement]¹¹.”

- 5.2 In addition to the operative text in the body of the Agreement, we propose to include the following language in an Annex to the Agreement which sets out further details and procedures for the compliance mechanism established by the provision set out in paragraph 5.1 above:

“Annex [XXX]

Procedures and mechanisms relating to compliance under the Agreement

In pursuit of the ultimate objective of the United Nations Framework Convention on Climate Change, hereinafter referred to as “the Convention”, as stated in its Article 2,

Recalling the provisions of the United Nations Framework Convention on Climate Change, and the Kyoto Protocol to the Convention, herein after referred to as “the Protocol”,

Being guided by Article 3 of the Convention,

Recalling Decision 24/CP.7 on the procedures and mechanisms relating to compliance under the Kyoto Protocol;

Recalling Chapter V, paragraph 8 of the Agreement;

The following procedures and mechanisms *have been adopted*:

I. OBJECTIVE

The objective of these procedures and mechanisms is to facilitate, promote and enforce compliance with the commitments under the Agreement.

II. COMPLIANCE COMMITTEE

1. The Compliance Committee established by Chapter II Decision 24/CP.7 on the procedures and mechanisms relating to compliance under the Kyoto Protocol shall act as the Compliance Committee in relation to the obligations of the Parties under the Agreement.

2. The competences and powers of the Compliance Committee acting as the Compliance Committee under this Agreement shall be as set out in this Annex [XXX].

3. The procedures and institutions established in relation to the Compliance Committee by Decision 24/CP.7, in particular the Plenary of the Committee (Chapter III of Decision 24/CP.7), the Facilitative Branch (Chapter IV of Decision 24/CP.7), the Enforcement Branch (Chapter V of Decision 24/CP.7), Submissions (VI of Decision 24/CP.7), Allocation and Preliminary Examination (Chapter VII of Decision

¹⁰ Depending on desired scope of the compliance mechanism.

¹¹ If “binding” has been included in the previous sentence, the last sentence is redundant.

24/CP.7), General Procedures (Chapter VIII of Decision 24/CP.7), Consequences applied by the Facilitative Branch (Chapter of Decision 24/CP.7) Secretariat (Chapter XVII of Decision 24/CP.7) shall apply mutatis mutandis to the Compliance Committee acting as the Compliance Committee under this Agreement.

4. The principles, competences, facilitative or enforcement tools and sanctions governing the scope and actions of the Compliance Committee acting as the Compliance Committee under this Agreement are set out below. In as far as these chapters contain references to specific provisions of and obligations of the Parties under the Kyoto Protocol, these shall, for the purposes of this Annex [XXX] be disregarded and deemed to have been replaced with the references to and obligations under the relevant provisions of the Agreement as set out in this Annex [XXX].

III. SPECIFIC TASKS OF THE FACILITATIVE BRANCH UNDER THIS AGREEMENT

1. With the aim of promoting compliance and providing for early warning of potential noncompliance, the facilitative branch shall be further responsible for providing advice and facilitation for compliance with:

- (a) Chapter I (A) (9)-(10) and Chapter I (A) (12) of the Agreement;
- (b) Chapter I (C) paragraphs (14- 16), (18-19), (20-22), (25- 27), (32-33), (48), (53) and (63);¹²
- (c) Chapter II (4)¹³;
- (d) Chapter IV paragraphs (4), (14) and (15);
- (e) Chapter VI paragraphs(3), (5), (7), (8) and (13); and
- (f) Chapter IX (1),

in particular, in each case, in relation to (i) the provision of any information a Party may be required to provide; and (ii) the development of policies and measures a Party may be required to develop.

2. The facilitative branch shall be responsible for applying the consequences set out in section XIV of Decision 24/CP.7.

IV. SPECIFIC TASKS OF THE ENFORCEMENT BRANCH UNDER THE AGREEMENT:

1. The enforcement branch shall be responsible for determining whether a Party to the Agreement is not in compliance with¹⁴:

- (a) Chapter I (A), (4);
- (b) Chapter I (C) paragraphs (14-16), (18-19), (28), (29), (38-39), and (46); and
- (b) Chapter III (6).

¹² The list of tasks of the Facilitative Branch under this Agreement ends here if the FB is only to be active in relation to Chapter I. If it is the intention that the compliance mechanism apply to all of the LCA, the remainder of the list is to be included in the text of this Annex [XXX].

¹³ Given the number of drafting options in Chapters II-IX, the following list of paragraphs is merely indicative and will need to be revised in detail once agreement has been reached as to the precise content of the relevant chapters.

¹⁴ The following list of paragraphs is merely indicative and will need to be revised in detail once agreement has been reached as to the precise content of the relevant chapters.

2. The enforcement branch shall be responsible for applying the consequences set out in section V below for the cases of non-compliance mentioned in paragraph 4 above.

3. The consequences of non-compliance with Chapter I (A) (14- 16) and (18- 19) to be applied by the enforcement branch shall be aimed at the restoration of compliance to ensure environmental integrity, and shall provide for an incentive, including financial incentives, to comply.

V. CONSEQUENCES APPLIED BY THE ENFORCEMENT BRANCH UNDER THE AGREEMENT

1. Where the enforcement branch has determined that a Party is not in compliance with any binding obligation¹⁵ under the Agreement, it shall apply the following consequences, taking into account the cause, type, degree and frequency of the non-compliance of that Party:

(a) Declaration of non-compliance; and/or

(b) Imposing of financial penalties; and/or

(c) Development of a plan in accordance with paragraphs 2 and 3 below.

2. The Party not in compliance under paragraph 1 above, shall, within three months after the determination of non-compliance, or such longer period that the enforcement branch considers appropriate, submit to the enforcement branch for review and assessment a plan that includes:

(a) An analysis of the causes of non-compliance of the Party;

(b) Measures that the Party intends to implement in order to remedy the noncompliance; and

(c) A timetable for implementing such measures within a time frame not exceeding twelve months which enables the assessment of progress in the implementation.

3. The Party not in compliance under paragraph 1 above shall submit to the enforcement branch progress reports on the implementation of the plan on a regular basis.

4. The imposition of financial penalties in accordance with paragraph 1(b), shall only relate to Parties' obligations which are of a financial nature. [Any such penalties shall be payable to the fund created pursuant to Chapter I (A) (10) of the Agreement.]¹⁶

VI. GENERAL PROCEDURES UNDER THE AGREEMENT

Each branch shall base its deliberations on any relevant information provided by:

(a) Reports of any relevant body under the Agreement¹⁷;

(b) The Party concerned;

(c) The Party that has submitted a question of implementation with respect to another Party;

¹⁵ Drafting Note: It would be preferable to include a list of precise obligations; however, given that the Agreement is a work in progress and that there are numerous drafting options within the current version of the Agreement, it may be more appropriate to list these once the body of the Agreement is nearer agreement.

¹⁶ To be considered in the light of negotiations regarding Chapter 1(A) (10) and related provisions under the Agreement.

¹⁷ The relevant bodies are to be listed once agreement as to their establishment under the Agreement has been reached

(d) Reports of the Conference of the Parties, the Conference of the Parties serving as the meeting of the Parties to the Agreement, and the subsidiary bodies under the Convention and the Agreement; and

(e) The other branch.

VII. SPECIFIC PROCEDURES FOR THE ENFORCEMENT BRANCH UNDER THE AGREEMENT

The enforcement branch may, in relation to any investigation in relation to any Party in accordance with section IV:

(a) adopt a preliminary finding that the Party concerned is not in compliance with commitments under one or more of the articles of the Agreement referred to in section IV; or

(b) otherwise determine not to proceed further with the question.

VII. EXPEDITED PROCEDURES FOR THE ENFORCEMENT BRANCH UNDER THE AGREEMENT

The expedited procedures for the enforcement Branch as per Chapter X of Decision 24/CP.7 shall not apply to the Enforcement Branch of the Compliance Committee acting as Compliance Committee under the Agreement.¹⁸

VIII. APPEALS

The Party in respect of which a final and binding decision has been taken may appeal to the Conference of the Parties serving as the meeting of the Parties to the Agreement against a decision of the enforcement branch if that Party believes it has been denied due process.

IX. RELATIONSHIP WITH THE CONFERENCE OF THE PARTIES SERVING AS THE MEETING OF THE PARTIES TO THE AGREEMENT

The Conference of the Parties serving as the meeting of the Parties to the Agreement shall:

(a) Consider the reports of the plenary on the progress of its work;

(b) Provide general policy guidance, including on any issues regarding implementation that may have implications for the work of the subsidiary bodies under the Agreement;

(b) Adopt decisions on proposals on administrative and budgetary matters; and

(d) Consider and decide appeals in accordance with section VIII.”

¹⁸ The expedited procedures of the enforcement branch apply in relation to the alleged non-compliance of a Party which may lead to a decision of non-eligibility to participate in the trading of assigned amount units. As the current draft of the Agreement does not contain references to the trading of Parties' obligations, we do not propose that this procedure be available under the Agreement.