March 6, 2001

MEMORANDUM FOR SECRETARY O'NEILL

FROM: **MARK SOBEL**
Acting Assistant Secretary
(International Affairs)

SUBJECT: Meeting with Gary Edson (NSC/NEC) on Steel, Global Climate Change, and AIDS

DATE/TIME: March 9, 2001, 2:30 p.m.

LOCATION: Secretary's Office

PARTICIPANTS: Yourself
White House Policy Advisor Gary Edson

ATTACHMENTS:

Overview	
Tab A	Steel
Tab B	Global Climate Change
Tab C	AIDS

Tab B **Global Climate Change**

Part One of this Tab B attachment offers some observations related to your memo to the President on global climate change and your comments at the briefing on February 21, 2001. Part Two provides some background on an area of particular interest to Treasury: the Global Environment Facility (GEF). While the GEF is not likely to come up in your meeting with Gary Edson, it may be helpful to be aware of Treasury's interest in this matter.

Tab B, Part One: Developing Administration Priorities on Climate Change

- You correctly note that the Kyoto Protocol targets, if instituted in 2008 to 2012 and continued unchanged by subsequent agreements, would produce only a brief delay in the buildup of atmospheric concentrations. However, the assumption of the Parties in the negotiations has been that each consecutive commitment period would involve different, likely more stringent targets, and the eventual inclusion of binding commitments by developing countries. Thus, the impact of the "Kyoto targets forever" scenario on concentrations is not necessarily the only, or even the most plausible, outcome of the Kyoto Protocol.

- You note the view that Kyoto could be used to push "the nose under the tent." Most economists familiar with climate change mitigation agree that, although the Kyoto targets and timetables are infeasible, a good mitigation approach would be to establish a modest carbon price signal and increase it gradually and predictably. A slow and predictable increase in the price signal allows the economy to adjust using long run elasticities of substitution towards less greenhouse gas-intensive production and consumption. This adjustment could, in theory, be accomplished with a series of commitment periods with reasonable but decreasing targets (perhaps in combination with a safety valve) as the basic Protocol structure envisages, or with approaches such as gradually increased harmonized taxes. A key problem in implementing the Kyoto Protocol is that short run elasticities are very low, making an ambitious first period target very expensive.

- If one includes the flexibility mechanisms, the effect of full implementation of the Kyoto Protocol would not necessarily mean that the U.S. needs to reduce *its own* emissions or energy consumption by more than 30% by 2008 to 2012. Models predict that over half of the emissions reductions the U.S. would require under Kyoto would be achieved by importing emissions allowances under the flexibility mechanisms.

Prepared by: Economic Policy

Tab B, Part Two: Global Environment Facility (GEF) and Climate Change

Summary Background:

The GEF, created on a pilot basis in 1991, helps finance investments in developing countries that yield global environmental benefits. One of the environmental issues that the GEF focuses on is climate change through support of energy efficiency and renewable energy projects.

A major crisis is looming for the GEF budget. The U.S. is in a serious arrears situation having made only one of four payments to GEF-2. The FY02 budget request asks for only one more payment. Going into the GEF-3 replenishment this year, the best case scenario will involve the U.S. making two of the four payments it owes. This will impact replenishment negotiations, particularly at a time when the GEF is being asked to help finance the new persistent organic pollutants treaty which the U.S. strongly supports.

Our arrears problems with the GEF are, in part, due to a misperception in Congress that the GEF is funding "back door" implementation of the Kyoto Protocol on climate change. Treasury has worked hard to prevent any association between GEF and Kyoto, and we were successful last year in getting language into the FY01 House Foreign Operations Committee Report articulating that this is not the case. However, the State Department's latest positions in climate negotiations, if permitted to prevail, will make it more difficult for Treasury to make this argument in the future. For example, several proposals discussed in COP-6 last November are of concern to us. These proposals (tradable emissions fund, Russia green fund, and adaptation fund) would directly link the GEF with Kyoto by having the GEF manage funds created out of two Kyoto Protocol mechanisms (i.e., tradable emissions system and Clean Development Mechanism).

Tradable Emission Fund:

Prior to COP-6, the State Department was considering a proposal to require the developed countries to give a certain percentage of their assigned tradable emissions credits to a fund for developing countries, and have the GEF manage this fund. This proposal would be used to counter another proposal by the developing countries, with EU support, to tax tradable emissions. The GEF, as fund manager, would then sell these credits and use the cash to assist developing countries in their climate change activities. The total amount per year could be around $100 million, depending on the price of carbon.

Our Issues:

- Associates the GEF with the Kyoto Protocol tradable emissions mechanism and what sounds like a tax by other means.
- Exceeds the GEF mandate, as it would be required to broker/facilitate emissions trades.
- Could be considered a give-away to developing countries of the hard-fought tradable permits system the U.S. obtained in the Kyoto Protocol and for which the World Bank Prototype Carbon Fund was created.

Russia Green Fund:

This proposal would use revenues from tradable permits to address Russia's environmental problems, and have the GEF manage this estimated $8 billion fund. Based on 1990 emissions rates, Russia will be allotted generous emissions permits that it does not need, which it can then turn around and sell. The origins and details of this proposal are unclear. However, given the Europeans' general dislike of using tradable emissions to address climate change, this would make the mechanism more palatable to them.

Our Issues:

- Associates the GEF with a Kyoto Protocol mechanism.
- Creates a precedent for the GEF to be a manager of other funds that may be created.
- Usage of funds unclear at this point.

Adaptation and/or Mitigation Fund:

In COP-6, a proposal was furthered to have the GEF manage an adaptation or mitigation fund which would be funded by the Clean Development Mechanism (CDM), a Kyoto mechanism. Although Treasury has previously been supportive of the idea of the GEF housing the Adaptation Fund (created by the Climate Convention), we have growing concerns that this will associate the GEF with the CDM (created by the Kyoto Protocol). According to State Department negotiators, it would be difficult for the U.S. to change its position on the GEF and the Adaptation Fund at this point.

The Adaptation Fund was created in the 1992 U.N. Framework <u>Climate Change Convention</u>, but the source of its fund was left for future discussions. The CDM was created in the <u>Kyoto Protocol</u> to enable industrialized countries to receive credit for financing emissions-avoiding projects in developing countries. The Kyoto Protocol also determined that a share of the CDM proceeds would be used to assist developing countries. Since Kyoto, countries have decided to fund the Adaptation Fund with the CDM proceeds. Most countries, including the U.S., and the GEF Secretariat have expressed support for having the Adaptation Fund housed in the GEF, but formal decisions will not be made until COP-6 resumes this summer. State has been supportive of the GEF managing this fund because the U.S. does not want to create any additional bureaucracies or mechanisms.

Our Issues:

- Governance structure for CDM would be in the U.N. system (i.e., UNFCCC) and Congress is not likely to support giving the U.N. such control over revenue U.S. businesses help generate which will essentially be transferred to G-77 countries. Mixing the GEF into this macroeconomic issue could further complicate GEF's problems in the Congress.

Prepared by: International Affairs