

November 30, 1997

MEMORANDUM FOR THE PRESIDENT

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SUBJECT: Kyoto -- Negotiating Guidance

As the climate change negotiations begin in Kyoto, we wanted to update you on the current state of play and identify issues on which your chief negotiators need bottom-line guidance. On a variety of issues, significant differences remain between us and other major players, such as the EU and G-77. An agreement at Kyoto is still possible, but it will require key countries to make significant concessions from their stated positions.

Of the many issues to be resolved at Kyoto, four are likely to require decisions from you: emissions targets, joint implementation with developing countries, overall developing country commitments and a national security exemption. On each of these, Stu Eizenstat will need to know where your bottom line is -- the point to which you could move from a current U.S. position, but beyond which you would consider an agreement unacceptable.

This exercise inevitably raises the question of what would happen in the event we refuse to support an agreement we deem unacceptable. The best case would be to negotiate some form of standstill agreement, in which countries would lock in the progress to date and commit to continued prompt negotiations on the remaining issues. This is the "process outcome" our negotiators would seek, but a more problematic result, with the U.S. relatively isolated and portrayed as the bad guy, is possible as well.

Targets

Among industrialized nations, the most significant outstanding issue is the level of the binding target. Key proposals on the table are as follows: EU -- 15 percent below 1990 levels by 2010; Japan -- 0-5 percent below 1990 levels by 2010, based on a formula that would produce different targets for different Annex I countries within this 0-5 percent range; U.S. -- 1990 levels by

2008-2012; Canada -- 1990 levels by 2010; Australia -- significantly above 1990 levels by 2010. When discrepancies in accounting methods are taken into account (e.g., the treatment of carbon "sinks" or the number of gases covered), we believe our target is somewhat closer to those of the EU and Japan than has been widely reported.

As you know that the EU has been able to be so aggressively green on its target only because of its "bubble". (The bubble allows different countries to have different targets -- the emissions of several EU countries would actually grow compared to 1990 -- so long as the EU as an aggregate reduced by 15 percent. In essence, the entire EU gets the benefit of the special circumstances that have produced significant emissions reductions in the U.K. and Germany.) However, opposition to the bubble is widespread. In order to get the bubble, the EU may well have to give on other points (including, for example, a differentiated regime in which countries without a bubble might get targets somewhat higher than the EU).

To reach a deal at Kyoto containing enough of the key elements of the U.S. proposal (joint implementation, developing country participation), a U.S. target below 1990 levels of greenhouse gas emissions may well be necessary. EU leaders are demanding a reduction below 1990 levels, as are many leaders in the developing world. A "reduction target" -- even a small one -- would allow these leaders to argue more effectively that Kyoto reflects real progress since Rio, where nations agreed to reach 1990 levels by 2000.

Optical reductions. There may be acceptable ways of recharacterizing the U.S. target that would show a reduction but not require greater effort on our part. Your advisors are actively exploring such options now. One such optical change to our target -- agreeing to defer inclusion of certain carbon "sinks" until methodologies improve -- would put us one or two percentage points below 1990 levels without any increased effort, though there could be downsides in such exclusion. In addition, the Japanese have proposed a technical change in the way three of the six covered greenhouse gases are accounted for. EPA is analyzing whether this change is appropriate and how large an optical reduction it could produce (probably no more than one to two percentage points).

Real reductions. You will likely need to decide whether, if it became necessary in the final endgame to get an overall deal, you would be prepared to reduce our target not just in optical terms but in real terms. Such a reduction could in theory come either in a first budget period (2008-2012) or a second budget period (2013-2017), though the EU and developing countries will press much harder for a reduction in the first period.

A. First budget period: The potential real reduction in the first period could be in the 1 to 5 percent range. Any reductions below the target you have already proposed would undoubtedly intensify the criticism by much of industry and many on the Hill. The problem is exacerbated by recent projections from the Department of Energy suggesting that carbon emissions will be 5 percent higher in 2010 on a business-as-usual path than previously thought. However, such

reductions may be necessary to close a deal at Kyoto with other key elements of our package.

B. Second budget period. It is possible that reductions in the second budget period -- presumably 5 percent or more below 1990 levels by 2013-2017 -- could also be helpful. Given the longer time horizon and the likelihood that such a target would be revisited before the second budget period begins, this could be more palatable to constituencies at home. However, other nations seem intent on reductions in the *first* period; it is unclear how much leverage a 5 percent reduction in the second period, or even a 10-15 percent reduction, would provide. Furthermore, committing now to specific reductions in a second budget period could remove leverage in future rounds of negotiations involving developing countries, and we could be criticized for agreeing to two targets before developing countries agree to any.

Joint Implementation

Your recent efforts to gain support for joint implementation have helped to provide momentum for its acceptance, and have sent a strong message to potential supporters that this remains a U.S. priority. Nevertheless, most key developing countries continue to oppose JI, and it remains very vulnerable. The current negotiating text is inconsistent with the U.S. position: it would allow joint implementation only among industrialized countries or with developing countries that voluntarily take on binding commitments under Article 10 (see below), and would postpone any decision on joint implementation with developing countries until after the completion of an ongoing pilot project, in 2000.

We are still working quietly with Brazil on a compromise proposal. However, the prospects for success are unclear.

In addition, you should know that many countries are seeking percentage limits on the use of joint implementation (for example, by limiting credits to 5 percent of a country's 1990 baseline). We have allowed our negotiators to consider qualitative rather than quantitative limits (e.g., "JI credits would be *supplemental* to domestic measures").

Joint implementation remains critically important to those moderate businesses which have been at least tentatively supportive of your plan, such as BP and several major utilities. The importance of JI is further underscored by the difficulty we are having in negotiating developing country commitments (see below). In the absence of strong commitments from developing countries, participation through mechanisms such as joint implementation becomes especially important. In addition, joint implementation and emissions trading are among the key devices that allow us to argue that the overall cost of reaching your climate change goals will be affordable -- well below the \$100-200/ton costs that opponents claim.

The questions for decision are (a) whether we must have joint implementation with developing countries for credit in the treaty; and (b) whether you would, at the limit, accept a quantitative restriction on JI.

Developing country commitments and the two-step process

In your climate change speech on October 22, you said that the "United States will not assume binding obligations unless key developing nations meaningfully participate in this effort." This hinted at, but did not explicitly detail, a "two-step" approach to the developing country issue. Under such an approach, we would reach agreement at Kyoto but not seek to ratify the agreement without further developing country commitments.

You should be aware that Senator Byrd (whose resolution, passed 95-0 by the Senate this summer, lays down a strong marker on this issue) wrote you this week to reject the two-step approach:

"I believe it would be unwise for the U.S. to be a signatory to any treaty that would not be approved by the Senate on its own merits. Those who are concerned about the consequences of climate change should consider that agreeing to only half a loaf --that binds only the Annex I industrialized nations to emissions limitations --will subject a protocol to intense domestic criticism as premature, unbalanced, and inequitable. Further, I believe it would make binding commitments by the developing world less likely as crucial negotiating leverage would have been lost."

Senator Byrd's views notwithstanding, the reality is that there is no prospect for developing countries to sign on to their own binding targets at Kyoto. In fact, the prospects for the strong Kyoto Mandate that our negotiators were once hoping for -- in which developing countries would agree *now* to commence future negotiations over binding targets within some period of time -- are close to nil.

It thus looks increasingly likely that the most we could realistically achieve in Kyoto is an opt-in mechanism (Article 10), under which any developing country could voluntarily accept its own binding target in the months or years ahead, plus a general statement concerning a follow-on process of future negotiations, in all likelihood without any specific reference to binding commitments. At its weakest, this reference to a follow-on process could take the form of a "review of commitments" for the world as a whole, a provision the EU would accept. Such a review could lead to, but would not guarantee, a new negotiation over developing country commitments.

Neither the opt-in mechanism itself, nor a general reference to a follow-on process, would represent "meaningful participation" by developing countries. Those devices are means to the end, not the end in themselves. Consequently, we would need to emphasize that we

would not expect to submit the treaty for ratification until a critical mass of developing countries were participating meaningfully. The reception of such an approach on the Hill and among business would likely be mixed -- but would likely improve a good deal if we had succeeded in getting joint implementation with developing countries.

The issue for decision is whether the two-step approach in this form -- with the Article 10 opt-in plus a general reference to a follow-on process -- is acceptable or falls below your bottom line.

Military/national security exemption

During the past several months, the Department of Defense has expressed several concerns about the climate treaty. DoD is concerned about the impact of emissions restrictions on U.S. military readiness, on basing negotiations with our allies, and on surge operations (e.g., Desert Storm/ Desert Shield and peacekeeping missions such as Bosnia). DoD accepts that its facilities, including buildings and non-tactical vehicles (about 42 percent of its total emissions), should be subject to greenhouse gas limits to the same extent as non-military facilities.

To address these concerns, we have shaped a package under which military operations and training (which account for roughly 0.7% of U.S. emissions) would be held harmless in any domestic emissions trading program. DoD's facilities would be covered by such a program. We have also pursued several issues under the climate treaty, including authority for the United States to take emissions from our military bases overseas into our national totals (which, due to downsizing, would likely make our targets easier to reach). This provision would address concerns about basing negotiations, and now appears achievable at Kyoto.

An outstanding issue, however, relates to surge operations. Our negotiators originally explored a treaty provision exempting emissions from surge operations, but it now appears unlikely that this can be achieved at Kyoto. We are currently exploring a number of weaker procedural devices, including a decision of the parties on this issue and a statement by the chair. Last week, DoD wrote the White House to state that a decision of the parties at Kyoto would address its concerns but that, absent such a decision, the U.S. should not join an agreement. In the event our negotiators are unable to obtain a decision of the parties or other means of addressing this issue, you will need to decide whether to proceed with the treaty nevertheless.

You should know that this issue -- the impact of the climate treaty on the military -- has received growing attention on the Hill and among industry groups opposed to the treaty.