

INECE Workshop on "Confidence Through Compliance in Emissions Trading Markets": Conference Report

Sustainable Development Law & Policy

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INECE WORKSHOP ON “CONFIDENCE THROUGH COMPLIANCE IN EMISSIONS TRADING MARKETS”:

CONFERENCE REPORT

by Sustainable Development Law & Policy*

INTRODUCTION

On November 17-18, 2005, participants from governmental, international, and non-governmental organizations from all over the world convened at American University, Washington College of Law in Washington, DC, to discuss the future of emissions trading (“ET”) systems. The workshop, entitled “Confidence Through Compliance in Emissions Trading Markets,” was convened by the International Network for Environmental Compliance & Enforcement (“INECE”). Trading systems are proving to be a successful means of reducing greenhouse gas (“GHG”) emissions, but they only work to the extent there is effective compliance and enforcement. Participants focused on ways to implement compliance and enforcement strategies into ET systems.

One of the workshop’s main goals was to promote information-sharing among participants, with special emphasis on compliance as well as the possibilities for linking trading systems to control emissions worldwide. Presenters shared ET experiences from around the world and explored the role that information technology and private stakeholders might play in ET schemes.

Through the comparison of experiences between the European Union’s Emissions Trading System (“EU ETS”) and the United States’ ET systems for SO₂ and NO_x, the workshop sought to: (1) establish a set of best practices and appropriate policy responses to compliance and enforcement challenges; (2) emphasize the important role that compliance and enforcement play in both reducing greenhouse gas emissions and increasing stakeholder confidence in the program and market; (3) identify key elements of an effective trading system; and (4) determine how best to create a “common currency” to allow for trading among different international trading systems.

KEYNOTE ADDRESS: CONFIDENCE THROUGH COMPLIANCE

Angelos Pangratis, the Deputy Head of the European Commission Delegation to the United States, delivered the keynote address for the opening day of the workshop. He discussed the EU ETS, the world’s first international, mandatory emissions trading system, and how its success is instrumental for future international efforts to achieve the drastic cuts in GHGs necessary to combat climate change. Because the success of this system will affect future initiatives, the EU ETS initiative is too important to fail. For emissions trading systems to meet their goals effectively and efficiently, though, it is necessary to have high levels of compliance. Mr. Pangratis concluded his

address with elements for a successful emissions trading system – public policy initiatives, a credible market system to encourage private sector involvement, and the need for developed countries to lead by example.

OVERVIEW OF WORKSHOP THEMES

CREATION OF VIABLE EMISSIONS TRADING SYSTEMS

Throughout the workshop, a common theme was that voluntary market measures alone are not sufficient to drive climate change policies – public policy that promotes emissions reductions at both the state and national levels is critical. In order to achieve large-scale emission reductions on a global level, a strong regulatory framework that creates a market for carbon reduction must be created. A viable option is an emissions trading system that provides economic incentives to reduce emissions. Such a system should then inspire the private sector to develop new technology and manufacturing processes that lead to further emission reductions. However, the effectiveness of such a system relies on the government’s ability to establish an effective regulatory framework. An effective framework, in turn, depends on achieving high levels of compliance.

In order for any ET system to work, both the public and private sectors must have confidence in the system, which requires that policies be enforced. Public opinion will play a big role in building confidence in trading schemes. If an ET system is highly visible in a society, that society might be more willing to participate generally in environmental policies, and might place greater demands on companies. Increased social pressure on the private sector will also build a greater sense of social and environmental responsibility in the public. However, public awareness and responsibility cannot be accomplished through regulation alone.

ADVANTAGES OF CAP-AND-TRADE SYSTEMS

A cap-and-trade system is created when governments limit emissions in a defined area and then allow trading within that area. The alternative is a command-and-control approach, in which the government relies solely on penalties to deter companies from excessive emissions. Workshop pre-

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senters agreed that cap-and-trade systems are more effective than traditional command-and-control systems for reducing GHG emissions. With respect to achieving high levels of compliance, a cap-and-trade system offers several advantages. First, it allows companies to freely choose their own compliance strategies, including how to yield the most economically efficient and environmentally effective results. Under a command-and-control system, however, firms are not given an option of how to reduce their emissions – instead they must follow set regulatory instructions and may be penalized for failing to comply.

Second, a trading approach encourages compliance by changing the roles of both the regulator and the regulated party and aligning their interests. Under a command-and-control approach, both parties might feel as if they are pitted against each other. Under a trading approach, though, both parties have a strong interest in maintaining market integrity. For example, regulated parties do not have an interest in cheating, because doing so would decrease the tradable value of their allowances in the system. Thus, when both parties' interests are aligned, the prospect of achieving higher levels of compliance is greater.

Finally, a trading approach offers greater transparency than a command-and-control type regulation, which in turn encourages public confidence in the system. An emissions trading system with an effective monitoring, reporting, and verification program will provide the public with a tangible means of evaluating the system's effectiveness. The public will have greater confidence in the data if the way in which it is collected is open and allows for obvious accountability. Additionally, greater transparency allows the public to better understand the role a trading system plays in emissions reduction. Under emissions trading systems, some of the cost of producing pollution-intensive products is internalized and passed on to the consumer. As such, transparency in the system can allow consumers to see the impact of their choices on the environment and adjust their purchasing decisions accordingly, thus increasing levels of compliance.

MONITORING, REPORTING, AND VERIFICATION

The success of an emissions trading system depends on how well emissions are monitored, reported, and verified, and these elements in turn are determined by the degree of compliance and enforcement. As such, monitoring, reporting, and verification ("MRV") procedures were a key focus of the workshop. In particular, workshop participants considered the necessary elements for an effective MRV program, and discussed the potential for cross-border MRV application.

Lessons Learned for Compliance and Enforcement

The workshop began with a discussion comparing different methods for compliance and enforcement in emissions trading systems. Christian Egenhofer, from the Centre for European Policy Studies, provided an overview of the European Union emissions trading model. Joe Kruger, from Resources for the

Future at the time of the workshop (now with the National Commission on Energy Policy), presented the U.S. emissions trading model. Respondents Leigh Mazany, from Environment Canada, and Kunihiko Shimada, from the Institute for Global Environmental Strategies at the time of the workshop (now with Japan's Ministry of Environment), provided insight on emerging trading models in Canada and Japan.

General lessons and recommendations became evident from such comparisons. In designing an effective emissions trading system, methods of achieving compliance and enforcement must be considered first and foremost. The key regulatory mechanisms for achieving compliance in an ET system are monitoring, reporting, and verification of emissions. With respect to enforcement policies, a country will also have to determine the kind of penalties (for example, discretionary or automatic) it wishes to apply for non-compliance. The presenters noted that compliance

In order for any ET system to work, both the public and private sectors must have confidence in the system, which requires that policies be enforced.

and enforcement policies must be expansive, and have a local, regional, and national focus. Such policies must also be comprehensive in covering both industry and the public. Furthermore, effective compliance and enforcement programs must ensure accountability and integrity by thoroughly measuring emissions and encouraging transparency for the benefit of the public. Though such a system must inherently be multifaceted, system designers must ensure that compliance and enforcement programs are simple to operate and implement.

Participants also emphasized the importance of information technology in an emissions trading scheme, particularly with monitoring. They noted that information technology could provide greater transparency in data collection and analysis, and encourage data sharing among program participants. It was also generally agreed that, when feasible, regulators should take advantage of technology in order to automate regulation of emissions. For example, the U.S. model relies heavily on computers and technology in its MRV program. In fact, the U.S. program is now generally "paperless," and much of the trading is done online. This has greatly contributed to the program's overall efficiency.

Overall, the presenters agreed that a successful MRV program would depend on a variety of factors, including: (1) eco-

conomic incentives for industry involvement; (2) clear roles and accountabilities for those regulating and enforcing the program; (3) transparency and engagement of stakeholders at all stages of program implementation; and (4) the program's cost-effectiveness.

Factors Affecting MRV in a Future U.S. GHG Trading Program

Should the United States attempt to limit GHG emissions, it is likely that they will turn to an emissions trading system. The United States has already established several successful trading programs for other emissions, such as SO₂ and NO_x, which cause acid rain. Mr. Kruger highlighted certain factors that the United States should consider when designing this system.

First, regulators must consider the point, or target, of the regulation, as this will affect how the system will be designed. Regulations can be targeted "downstream" at the power sector, "upstream" at the economy at large, or using a hybrid of both down- and upstream for greater coverage.

Second, the United States should consider using continuous emissions monitors ("CEMs") to monitor GHG emissions. CEMs are a more comprehensive method of monitoring emissions, which collect data on each ton of emissions from each regulated unit. This method is used by the United States to monitor other emissions, but is not mandatory. For an ET system, reliance on CEMs would depend on the point of regulation and whether CEMs are already in place.

Third, the United States will have to determine the impact of state and regional programs. Several states and regions have taken initiative in experimenting with cap-and-trade systems. Building on existing CO₂ regulatory programs would make implementing a large-scale trading system more efficient.

Finally, the United States should consider experimenting with voluntary initiatives. Voluntary protocols, however, would require adaptation for mandatory programs. In particular, this might create tensions over who bears the burden of the program's costs. Furthermore, the level of reporting required for a voluntary program would be different than that for a mandatory program. The regulators would have to consider who would do the reporting – whether it would be performed internally by the company or externally by a third party. Experimenting with voluntary programs, however, would be useful to inform future mandatory protocols.

Linkage Systems

A major focus of the workshop was how different countries' emissions trading systems could be linked to provide for more effective and comprehensive emissions control worldwide. Although linkage will depend on a wide range of factors, workshop participants agreed that a truly global ET system would best function with uniform, or, at least harmonized, MRV requirements. A common language and vocabulary would also be necessary to design a comprehensive, multi-national trading scheme. Linkage would also require strong political will, and would raise various issues regarding the role of developing countries.

Verification and the Verifiers

Several presentations and working groups focused on the verification aspects of an emissions trading system. In particular, who should verify emissions and how should that verification be performed? In the United States, for example, verification is primarily performed by the government, which relies heavily on electronic monitoring and occasional site inspections. The EU, on the other hand, relies on third parties to verify emissions. However, the EU currently has no uniform standards of verification or accreditation for those third party verifiers. As such, one of the issues addressed at the workshop was whether it would be possible to develop an EU-wide body that could accredit verifiers, rather than having each Member State oversee its own verifiers. Such a comprehensive program would result in more uniform standards, and thus, more confidence in the results.

One possibility discussed was hiring professional verification and certification firms. Such firms would be competent, independent, and accredited. An independent firm would provide consistency in emissions reporting (over time and across borders), transparency (clear, factual reports that could be replicated), independence (they would be free from bias and conflict of interest), ethical conduct (with trust, integrity, and confidentiality), fair presentations (which would be truthful and accurate), and due professional care (which would inspire confidence in stakeholders).

Third party verifiers would provide several benefits, including avoiding bureaucracy, providing for greater separation of powers, increasing efficiency, and spreading liability. Furthermore, third party verifiers could provide a knowledge transfer from the private sector to the government. Workshop participants also stressed the importance of accreditation processes for verifiers and penalties – including criminal sanctions – for dishonest verifiers. The participants expressed an urgent need for high-quality verifiers in order to implement its ET system more efficiently.

WORKING GROUP SESSIONS

Participants divided into small working groups on each day of the workshop. On the first day, working groups evaluated the similarities and differences between EU and U.S. MRV models. On the second day, working groups discussed potential best practices for international harmonization of trading systems.

DAY ONE: COMPARISON OF MRV SYSTEMS IN THE EU AND U.S. MODELS

At the first working group session, participants divided into four smaller groups that focused on comparing costs between EU and U.S. emissions trading system approaches, institutional responsibilities in MRV, the role of information technology in emissions trading systems, and the role and potential for further development of third party verification.

Working Group One: Cost Comparison between EU and U.S. Approaches

This group first identified three major costs for implementing emissions trading systems. First, the group acknowledged the cost

of establishing the emissions trading scheme, which typically falls on the country's government. Second, there will be specific process-oriented costs for monitoring, reporting, and verification. Finally, there will be auxiliary costs. The group questioned whether such costs would be financially beneficial (as a boost to alternative industries and technological innovations) or detrimental to companies (by increasing pressure for reporting at the cost of confidentiality). The group also commented that these costs might affect small and large businesses differently.

Next, the group examined the costs that would fall on the government. The group observed that the government's fiscal reality would have a significant impact on the financial structure of the trading system. As one participant noted, not all governments can afford to hire new staff to travel around the country and conduct verifications.

When both parties' interests are aligned, the prospect of achieving higher levels of compliance is greater.

The group concluded its session with recommendations for further analysis of EU and U.S. trading systems to identify where the costs are and who is currently bearing them. The group noted that because the EU and U.S. trading systems are so distinct from one another, a comparison between the two systems might reveal more efficient cost-sharing strategies. Overall, the group suggested that countries developing emissions trading schemes must focus on efficiently dividing costs between the public and private sectors.

Working Group Two: Institutional Responsibilities in MRV

This group examined what kinds of rules should govern the MRV program for an emissions trading system. The group first noted that strict, formulaic guidelines did not work, and that for the U.S. system, more prescriptive guidelines were needed. The group found that there is a great need for flexibility in such MRV operations, and that in particular, industry desired a greater degree of certainty.

The group then proposed a third party verification system, and compared current programs in the United States and the EU. The group found that initially, third party verification sounds very appealing. Third party verification would provide a means to avoid burdensome bureaucracy, increase the separation of powers and responsibilities of those involved in the trading system, and facilitate appeal procedures. Overall, the group thought that a third party verification system has potential to dramati-

cally improve a trading system's efficiency.

Furthermore, the group found that a third party verification program could be quite advantageous to a large trading system, such as the EU, which encompasses 25 different jurisdictions. Third parties would help a large system develop a uniform template for MRV that would provide consistency among the different jurisdictions.

The group also highlighted other advantages of third party verification. Third party verification would spread liability, for instance, and allow for an efficient transfer of knowledge and capacity from the private sector to the government.

The group warned, however, that more research into defining the appropriate level of assurance of verification would be needed to ensure that third party verifiers have universal qualifications, and to ensure that conflicts of interest do not arise between third party verifiers and their clients.

Working Group Three: The Role and Potential of Information Technology to Automate MRV

The United States has had great success in using information technology ("IT") to monitor, report, and verify emissions. This group examined whether the EU might also benefit from shifting to a more automated MRV program. Reliance on IT can be beneficial to an emissions trading system because it can reduce costs, improve consistency and efficiency, and contribute to building greater confidence in compliance.

The group first discussed the role IT plays in the U.S. MRV program. The U.S. system has been evolving dramatically over the last decade, including significant improvements in the use of electronic auditing and quality assurance and quality control ("QA/QC") testing requirements. The United States has tried using automated verification checks with some success. However, such a system is limited in its application to certain emission sources, such as those produced by cement plants or using mixed fuels.

The IT system in the EU, on the other hand, is in its initial growth stage. The group noted, however, that there is a significant push towards automating the monitoring, reporting, and verification of emissions data. Currently, there seems to be a window of opportunity to create a uniform system of MRV using IT in the EU, but – the group warned – it must be done before ad-hoc systems develop, which become difficult to change. The group highlighted the fact that, even with automated and standardized systems, the opportunity for data exchange is critical. Otherwise, a significant data entry burden might be created.

Overall, the group found that the most important element of an effective IT system is transparency. In the United States, emissions data is publicly available. In the EU, however, emissions data is treated very differently – it is made confidential for 25 years or more. Transparency is important because it builds confidence among both market stakeholders and the public.

The group concluded with recommendations that interested parties should look for opportunities to share more ideas on creating an effective IT system. In particular, the group suggested

that a standard form for submissions be created, although it noted that this might be difficult to do given varying interpretations of certain directives. The group also highlighted the need for education – of both public and private stakeholders – on the benefits of an emissions trading system. Furthermore, a push for the creation of electronic mandatory reporting would force a new way of looking at the system. This might push all parties to become involved in creating a more effective system, rather than simply implementing electronic capabilities within the old system.

The group also noted that because many issues in the EU are generally left to the Member States to resolve, it might be beneficial to create a reference MRV model that all the Member States could refer to when developing their own systems. Despite the potential lack of political support for such a system, the group strongly suggested that an MRV system should be developed that would be “ready to roll out” once the political will to implement such a system is present. This has been done in the United States – a reporting and verification system is in place in the event that political support is granted. The United States could cooperate with the EU to design a similar system.

Finally, the group emphasized the need for another INECE workshop in the second half of 2006 on the role of IT in MRV systems. The workshop would need to focus on addressing the many issues involved with implementing IT systems – in particular, how to improve ease of use of such a system, and how to promote consistency among different systems. The group suggested designing a hypothetical plant and performing simulations of how U.S. and EU systems would operate at this plant. Overall, the group found that IT, as a standardized system, could build confidence, increase compliance, and promote greater cost effectiveness in an emissions trading system.

Working Group Four: The Role of Third Party Verification

This group examined the role of third party verification, and focused on exchanging lessons learned by the UK and United States. The United States relies heavily on the government to verify emissions levels, whereas the UK relies primarily on third party verifiers. The group found that the main difference between the U.S. and EU verification system was accountability – while the United States primarily holds only the source liable, the UK may hold both the source and verifier liable for incorrect emissions data collection. In the United States, most industries report emissions data themselves. Therefore, someone in each particular company is responsible for reviewing and approving emissions data. If the data proves incorrect, that particular person may be prosecuted. In the UK, in contrast, a third party company reviews and approves emissions levels. That third party verifier then signs a statement approving the emissions levels and gives that statement to the environmental enforcement department. If those calculations are wrong, the third party verifier may be held liable in addition to the company producing the emissions. There is a little tension in the UK system, though, because typically the operator of the plant pays

the verifier for his or her services. Even though verifiers in the UK need to meet certain independence requirements, there is still a suggestive link between the company and verifier, because of who pays the verifiers’ costs.

The working group emphasized the importance of competency requirements in order to have an effective international verification system, and examined the U.S. and UK accreditation systems for guidance. The UK accreditation process requires that a verifier show independence from the company he or she will be verifying. Additionally, the verifier must be competent to collect data, and objective in assessing results. Because UK industries must pay for verification, accreditation ratings allow industries to choose the most cost-effective verifier for their company. Even though this might reduce the financial burden on the government, it has the potential to create a trade-off between price and quality.

This group also looked at whether the United States was considering third party verification, and whether it would be feasible without a huge shift in philosophy. U.S. government representatives in the group responded that the United States was unlikely to shift towards a third party verification approach; rather there has been an apparent shift in environmental management to self-auditing processes. One question with which the

Who should verify emissions and how should that verification be performed?

United States has recently struggled is whether leniency would be granted if a company performed a self-audit and identified a problem. To some degree, the U.S. system fosters third party verification, but it is not entirely independent. Many industries will bring in third party companies to help with the monitoring and reporting, but since these companies work at the request of the industry, their independence may be diminished.

The group concluded with some factors to be considered for establishing an inter-jurisdictional verification program for the EU. In particular, the group highlighted the need for language requirements (verification forms and guidelines should be in a single universal language, but auditors need to retain the ability to interpret regulations and documents in local languages), universal competency requirements, and incorporation of varying accreditation approaches.

DAY TWO: BEST PRACTICES FOR CROSS-BORDER HARMONIZATION

At the second working group session, workshop participants divided into two smaller groups to discuss the role that

INECE could play in assisting the development and linkage of inter-jurisdictional MRV schemes, and how cooperation between industry and government could help achieve greater compliance in emissions trading.

Working Group 1: MRV Linkage Issues

This working group focused on the international climate change enforcement community's immediate, intermediate, and long-term needs to facilitate MRV linkage issues. In particular, the group found that INECE could provide considerable assistance by providing a knowledge base for design, monitoring, and enforcement strategies, a compilation of "lessons learned" case studies, and guidance on accreditation and training of emissions verifiers.

The group first focused on the immediate needs of the EU. At the time of the workshop, there were fewer than one hundred working days until the first year of the EU's monitoring system was completed, and some two hundred days until the verification of emission reports was to be completed. As such, the group found that there was an immediate need for IT assistance – particularly with single-window interfaces, and generally with strategies for

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using IT in emissions trading regimes. The group suggested the need to bring EU regulators in touch with regulators from other countries that have had some success with these IT models, such as the U.S. Environmental Protection Agency ("EPA").

An overall lack of human resources was another immediate need highlighted by the group. The lack of trained certifiers posed significant problems in the short-term, especially for smaller markets like Australia. The few qualified professionals are primarily located in countries with larger markets. As a result, the best experts and technical consultants are often too busy to take on new clients. One group member pointed out, for example, that the same consultant worked for both the Canadian government and the EPA. One solution to this human resource problem might be a centralized list of qualified technical consultants.

The group next shifted its focus to intermediate needs, and found a great need for an international information knowledge base. The group noted that countries are currently in various

stages of implementing emissions trading systems. However, the group pointed out that often these countries' long-term goals are the same, so there is great potential for knowledge sharing.

The group identified a need to promote best practices for the design of emissions trading systems. One participant noted that because emissions are an artificial commodity, their trade does not happen in a naturally occurring market, and as such, their market must be specially designed. Australia, for example, has created a special task force to investigate the feasibility of creating a conventional cap-and-trade approach. Designers have discovered that there currently exists no comprehensive resource that details a decision tree that regulators could use to help establish such a market.

There is a need to bring together case studies, best practices, resources, evaluations, and handbooks. Such resources are or will be available, but are not located in any centralized location. For example, the EPA produced a "Tools of the Trade" manual based on their system. Furthermore, the EU will begin evaluation of their system early this year, and conclusions and "lessons learned" analyses might be available as early as summer 2006.

The group also suggested canonizing the fundamental elements of a carbon-trading regime. Two systems might employ different monitoring techniques but with the same objective of having accurate and timely information about emissions levels. Often systems that look quite different from a technical point of view are fundamentally quite similar. Reducing various systems to their fundamental elements might assist in the evaluation of regional systems.

The group also found that an important intermediate need is training. However, there is a lack of adequate training resources. The group noted that while we might still be several years away from the first university degree in Emissions Regulation, demand for qualifiers would remain high, especially in the smaller markets. The group suggested that INECE could collaborate with private industry, particularly insurance companies, to develop accreditation standards for emissions verifiers. The group proposed that eventually such discussions would move from accreditation standards to training. As a result, universities could develop curricula to train verifiers and relieve the human resource shortage. The group also noted that training would be fundamental to developing a common parlance in the industry.

In terms of long-term needs, the group found that all immediate and intermediate efforts would ultimately promote more efficient systems further down the line by promoting common international parlance for emissions regulation. Common objectives will come from common parlance.

Working Group 2: Potential for Industry and Government Cooperation

This group discussed what obstacles and opportunities were available for government and industry to cooperate with each other in order to achieve more effective compliance in emissions trading. Participants found that trust was the key quality


needed for harmonization of industry and government cooperation. To achieve trust, the group suggested that both sectors needed to increase integrity and confidence in the program itself. This could be done by making information available to the public and developing a system that would effectively resolve disputes concerning confidentiality. The group noted that because of the tension between transparency and confidentiality, shaping public perceptions must incorporate strong rule-making procedures that will allow for regular support and evaluation as well as strategic planning and changes.

The group concluded with a finding that a multidisciplinary approach was necessary, but that government and industry needed to share common values to encourage emissions trading, and full cooperation from stakeholders would be critical to the system's success. The group found that industry's reluctance to accept trading systems could be alleviated by providing greater certainty and flexibility (for example, by having coherent, but flexible, government policy) and by promoting effective communication. Group participants agreed that emissions trading systems could be encouraged through political interest and pressure, presentation of successful examples, education of small

and medium-sized firms, and assistance in technology and infrastructure to new EU member states.

CONCLUSION

The workshop concluded with a discussion of what "next steps" should be taken. Many participants proposed further areas of needed research regarding emissions trading systems. Such research suggestions included: (1) examining the role of the private sector and environmental regulations; (2) analyzing how to best bring verification, environmental management systems, information technology, and industry together; and (3) determining a common currency – comparing technologies on a technical level and comparing different regulatory cultures.

Workshop participants unanimously decided that future meetings were necessary, and that definite timeframes, deadlines, and goals should be determined to facilitate effective and efficient progress in the field of emissions trading. 

Power point presentations from the workshop are available on the INECE website at <http://www.inece.org/emissions>.

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