



Global Greenhouse Emissions



T R A D E R

A quarterly newsletter dedicated to greenhouse gas emissions trading

UNCTAD and UNEP launch international working group on the Clean Development Mechanism

by Frank T. Joshua

Last September, UNCTAD and UNEP launched a process of reflection on the issues and options relating to the design and implementation of the Clean Development Mechanism (CDM). The process involved a series of working group meetings on the technical, financial and institutional aspects of the CDM. The first workshop, held in Ottawa, Canada, on 22–23 September 1998, brought together more than 60 experts from developed and developing countries, public and private sectors, as well as from inter-governmental and non-governmental organizations.

Four working groups were established dealing with:

- project design and implementation aspects of the CDM;
- international trading aspects of the CDM;
- financial aspects of the CDM; and
- institutional aspects of the CDM.

The working groups were chaired respectively by UNIDO, UNCTAD, UNDP and UNEP. The second meeting of the working groups was held in Buenos Aires, Argentina, on 3 and 5 November 1998, in conjunction with the fourth Conference of the Parties (COP4). This meeting was equally well attended. Developing countries were particularly in evidence with experts from Brazil, China, Colombia, Ecuador, Guatemala, India, Kenya, Nigeria, Pakistan, Panama, Paraguay, Peru, Senegal and South Africa.

The groups have been working on the basis of a 'Concept Paper' prepared by a team of authors including Dean Anderson, Malik Amin Aslam, Charles Croswaithe-Eyre, Philippe Sands, Richard Stewart, Marc Stuart, and Farhana Yamin, with additional contributions from Grace Akumu (Kenya), Joe Asamoah (South Africa), Valentin Bartra (Peru), Ged Jones (UK), R. P. Karimanzira (Zimbabwe), Ray Kopp (USA), S. I. Nyagba (Nigeria), Cedric Philibert (France), Marina Ploutakinha (UNIDO), Eveline Trines (UK), Christiaan Vrolijk (UK), and ZhongXiang Zhang (The Netherlands), on a wide range of technical issues. (The concept paper and other technical papers can be found at: www.unctad.org/en/subsites/etrade).

A third and final meeting of the working groups will be organized in Paris, 11–12 March 1999, under the joint auspices of UNCTAD, UNDP, UNEP, and UNIDO. The final report of the working groups is due to be completed by the end of April 1999.

The Kyoto Protocol contains a number of provisions that should guide the design and implementation of the CDM. These include:

- provisions for management and supervision of the CDM by the Conference of the Parties serving as the Meeting of the Parties (COP/MOP) and the executive board;
- certification by operational entities on the basis of: voluntary participation to be approved by each Party involved; real, measurable and long-term benefits related to mitigation; and reductions in emissions that are additional to any that would occur in the absence of the certified project activity;
- assistance in arranging funding of certified project activities;
- the elaboration by the COP/MOP of modalities and procedures to ensure transparency, efficiency and accountability through independent auditing and verification of project activities;
- using a share of the proceeds from project activities to cover the administrative expenses of the CDM and assist particularly vulnerable developing countries to meet the cost of adaptation;
- the involvement of private and/or public entities in project activities and credits trading; and
- arrangements for the early start-up of the system from the year 2000.

The work programme on the mechanisms agreed at COP4 in Buenos Aires gave priority to the work on the CDM, with a view to taking a final decision on the mechanisms (under Articles 6, 12, and 17) at COP6 in the year 2000.

Frank T. Joshua is Head, Greenhouse Gas Emissions Trading, UNCTAD Secretariat

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In this issue of the Global Greenhouse Emissions Trader we provide readers with shortened versions of two technical papers on the CDM prepared for the working groups: one on the potential size of the CDM, by Christiaan Vrolijk; and the other on defining CDM baselines: criteria and rules for early implementation, by Dean Anderson

The potential size of the CDM

by Christiaan Vrolijk

Under the Kyoto Protocol the Annex B countries will take the lead in limiting and reducing emissions of greenhouse gases (GHGs). The Protocol sets emissions targets for the developed countries, which they can fulfil individually or jointly, making use of the cooperative mechanisms provided for in Articles 6 (JI), 12 (CDM), and 17 (emissions trading), and other forms of flexibility in the design of the Kyoto Protocol. These *Kyoto mechanisms* are expected to lower the costs of meeting the binding targets substantially. The inclusion of several gases other than CO₂ as well as some forms of removal and sequestration of gases within Annex B will also greatly reduce costs of emission reductions. Indeed, studies to date show cost reductions from emissions trading exceeding 50 per cent for Annex B countries, and even higher for some specific countries.

Many Annex B countries are anticipating difficulties in meeting their Kyoto commitments through domestic measures only, and as a result they are looking to the mechanisms for a solution of their problem. They are eager for the design of the mechanisms to proceed expeditiously. Several non-Annex B countries are interested in seeing progress made towards implementation of the CDM, which has the potential to channel substantial investment in clean, sustainable projects to developing countries. The CDM gives Annex B Parties the chance to achieve some of their reductions at lower cost by investing in projects in developing countries, where the marginal cost of abatement may be lower. Because of these reasons

Emission changes from 1995 to Kyoto target (MtC)

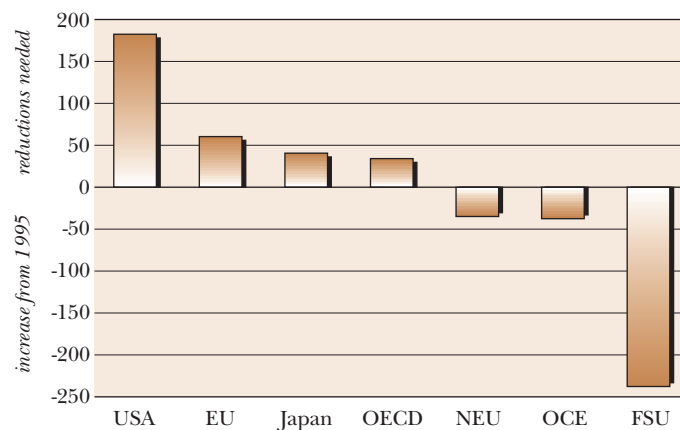


Figure 1: the cost reducing potential of emissions trading is clear; whilst some countries' emissions are too high, others have spare quota (compared to their 2008–12 targets). Source: Grubb and Vrolijk¹

the CDM has received much attention in Buenos Aires.

Some questions arise: How big will the market be, both in emission credits and in monetary terms? The objective of this paper is to provide a preliminary answer to this question. Of course, the quantification of the CDM market will depend heavily on the rules established for the CDM and the other mechanisms. A central assumption in most estimates presented here is the interchangeability of the emission reductions from the various mechanisms.

Market potential

Figure 1 displays clearly the cost reducing potential of emissions trading: some countries' emissions are too high, others have spare quota (compared to their 2008–12 targets). The market of the Kyoto mechanisms is also dependent on the growth of emissions due to economic development. On the demand side, the projected emissions for each Party in excess of its target comprises the total potential demand on the emissions market. The supply side of the emission

quota market is more complicated: some quota may be available because some countries' emissions will stay below the target; some emissions reduction measures will be taken by Parties independent of price signals; and other investments (through both JI and the CDM) could be made if the price is right.

The total emissions of the OECD are projected to exceed the targets by 580–1160 MtC in 2010² (various sources), while the countries with economies in transition (EITs) are believed to have large amounts of spare quota. Roughly speaking, the demand for reductions is around 1000MtC in Annex B countries and supply of (hot air) quota is between 100–300 MtC. In total Annex B countries are expected to need 440–830 MtC reductions, partly from their own domestic measures, from the large potential of cheap reductions in the EITs, and from emissions credits created in developing countries through the CDM.

Only a limited number of studies have incorporated estimates of the size of the CDM. The estimates, given in Table 1, range from \$5–21 billion annually in

¹ See for example Grubb and Vrolijk, *EEP Climate Change Briefing, No. 10*, December 1997, and *No. 11*, April 1998.

² *International Energy Outlook 1998*, EIA, 1998; *World Energy Outlook*, IEA, 1996; *European Energy to 2020: A Scenario Approach*, EC, 1996; National Communications as compiled by Grubb and Vrolijk, *EEP Climate Change Briefing, No. 11*.

Table 1: Estimates for the CDM market

Study	Market share (%)	Market size (MtC)	Market price (\$/tC)	Market value (\$bn)
Haites	27–57	266–572	37	9.8–21
US Administration	19–46	144–344	24–42	6.0–8.3
Austin <i>et al.</i>	33–55	397–723	13–26	5.2–17.4

monetary terms, and 144–723 MtC in emission reductions. Haites³ estimates range includes a supplementarity scenario (trade should not exceed 50 per cent of reductions from BAU), but the quota price is fixed. The US Administration⁴ studied the impact of the Protocol on the US economy. Here, their estimates are extended to include the whole of Annex B. The range includes, apart from standard CDM, an estimate for full trading with key developing countries (larger market size, and substantially lower prices). Austin, *et al.*⁵, derive their estimates from four different models.

Modelling the mechanisms

The author and Dr Michael Grubb developed an emissions trading model (ITEA)⁶ that creates marginal abatement

cost curves for each Annex B country, distinguishing between CO₂ and the other GHGs. The ITEA model is designed to quantify the impact of the Kyoto mechanisms, but only referring to relative costs. Initially developed before Kyoto the model was only recently expanded to include the CDM. An analysis has been made and the results are shown in Table 2. Note that the overall costs of Annex B and the CDM value are given in relative terms compared to the scenario of domestic action only. The CDM-restricted case uses a potential for this mechanism equal to half of the total non-Annex B CO₂ emissions in 2010; the potential with CDM-large is equal to the projected 2010 emissions; in the last scenario the marginal costs are halved for the CDM.

The estimates of the value of the

CDM of the ITEA model are comparable with the low range in other studies presented above. The size of the mechanism, however, is at the maximum, half the average of the other studies. Which of the outcomes is more likely? The CDM is a project-based mechanism. How many projects are likely and what is their total emission reduction potential? A number of bottom-up approaches are given below.

Bottom-up approaches

In August 1998 the Dutch government decided to reserve NGL500 million, around \$250 million, for the CDM after the year 2000; other money is available for JI projects in the EITs. Assuming a quota price of \$20/tC The Netherlands could buy up to a third of reductions

Table 2: Results of the ITEA study (compliance costs domestic action only = 100)

Scenario	No restrictions			Excluding hot air		
	Annex B costs	CDM value	CDM size(MtC)	Annex B cost	CDM value	CDM size(MtC)
Domestically	100	–	–	100	–	–
with Annex B trade	12.7	–	–	28.3	–	–
with CDM restricted	8.8	2.77	67	19.7	6.16	101
with CDM large	6.8	3.24	103	15.1	7.18	154
with CDM large and low costs	4.6	2.99	141	10.3	6.62	210

Source: ITEA (1998), author.

Note: According to Ellerman⁷ the compliance costs for Annex B are \$120 billion, without trade or CDM. Using this estimate, the total market of the CDM could be \$3.3–3.9 billion without restrictions, or double when some method is found to exclude hot air in the emissions market.

³ Erik Haites, *Estimate of the potential market for cooperative mechanisms in 2010*, Toronto, 11 September 1998

⁴ *The Kyoto Protocol and the President's Policies to Address Climate Change*, US Administration, July 1998

⁵ Duncan Austin, *et al.*, *Opportunities for financing sustainable development via the CDM: a discussion draft*, 7 November 1998

⁶ See for example Grubb and Vrolijk, *EEP Climate Change Briefing, No. 10*, December 1997, and *No. 11*, April 1998

⁷ Ellerman and Decaux, MIT, *Analysis of Post-Kyoto CO₂ Emissions Trading Using Marginal Abatement Curves*, 1998



needed from BAU through the CDM. The Netherlands emits less than 2 per cent of the total from non-EIT Annex B countries. If this investment is a good measure, the CDM might be worth around \$2.5 billion per year. For comparison, the Dutch development aid is more than \$1 billion.

Starting 59 new projects, similar to this effort in the AIJ pilot phase⁸, each year from 2000, with early crediting, could deliver some 63 MtC, or 12.5 MtC for each of the five years in the commitment period. Assuming that the AIJ projects in the EITs will lead to JI, only a total of 27 projects so far would lead to investment under the CDM. Also, most of the projects so far have been in forestry, of which inclusion in the CDM is still disputed. We would need to step up the effort dramatically to come even close to the low end of the macro-economic projections presented above. Note that the number of projects by the end of the commitment period will have risen to many thousands.

A specific project in the energy sector, depending on agreement on the rules and guidelines, could be the upgrade of an old coal-fired power plant. However, around 50 per cent of all these plants in the developing countries will have to be upgraded from an average of 25 per cent efficiency to western standards to reach the low end of the projected CDM market size. Forestry projects are likely to be cheaper, but a country like The Netherlands would need to plant forests on an area twice the size of the country itself to achieve its reduction target.

Money matters

The financial flows under the CDM projected here are not large compared to the volumes of money in any Annex B economy. However, it is more appropriate to compare this estimate with the financial flows in the DCs. For example, the present aid (ODA) from Annex B to DCs is around \$50 billion per year—a CDM of \$10 billion therefore would add 20 per cent to these flows. Another comparison could be made with foreign

direct investment (FDI), currently running at around \$240 billion. The CDM (again of \$10 billion) would add only around 4 per cent to investments in DCs. However, the CDM value quoted here should only be the additional value to the project investments. It doesn't seem likely that projects with high added costs will be implemented; added costs in the range of 2–10 per cent of the project costs are more likely. Thus half of all FDI could be redesigned to fit the CDM criteria. And that would make the CDM a powerful tool.

Conclusions

The potential exists for the CDM to become a multi-billion dollar business. Under the Kyoto Protocol targets, Annex B countries must reduce emissions by around 700 MtC. Part of the needed reductions will take place domestically; the rest will come from emissions trading and joint implementation, mainly through transfers of quota from the EITs to the OECD countries, and from the CDM.

Uncertainty about the final rules of the CDM make projections difficult. The macro-economic estimates (most of these are based on computer models) range from 67–723 MtC and \$3.3–21 billion. Some supplementarity studies have been done as well, resulting in substantially smaller sizes and lower values. The bottom-up estimates presented here can, at maximum, only support the lower range of the top-down analyses.

The money, although it may seem only a small amount, does matter. The estimated value of the CDM could be substantial compared to ODA, which totals around \$50 billion annually. Also, assuming that the carbon reduction costs only comprise 1–10 per cent of the total project costs, credits could accompany a large share of FDI in developing countries.

Christiaan Vrolijk is Research Fellow Climate Change, Energy and Environmental Programme, Royal Institute of International Affairs, London.

Forthcoming events

March 1–3, 1999, Toronto, Canada

Domestic GHG Emissions Programme: A Comparison of Progress Around the World, organized by National Round Table on the Environment and the Economy (NRTEE)

Contact: Moira Forrest, Manager of Communications

Tel: (1) 613 992 7157 E-mail: forrestm@nrtee.ca

March 11–12, 1999, Paris, France

Third Meeting of the Ad Hoc International Working Group on the Clean Development Mechanism, organized by UNCTAD, UNDP, UNEP, and UNIDO

Contact: Frank T. Joshua, Head, Greenhouse Gas Emissions Trading, UNCTAD Secretariat

Tel: (41) 22 917 5834/5831

Fax: (41) 22 907 0274

E-mail: frank.joshua@unctad.org

March 24–25, 1999, Sydney, Australia

Second Australasian Emissions Trading Forum, organized by IBC Conferences for the Australian Financial Review

Contact: Haley Morris, Senior Conference Manager, IBC Conferences, Sydney, Australia

Tel: (61) 2 9290 1686 Fax: (61) 2 9290 2577

E-mail: hayley_morris@ibcoz.com.au

April 26–27, 1999, London, UK

Second Annual Conference on Emerging Markets for Emissions Trading, organized and promoted by Global Village Conferences. Endorsed by UNCTAD and the Institute of Petroleum

Contact: Global Village Conferences, London, UK

Tel: (44) 171 538 1700 Fax: (44) 171 538 4244

E-mail: info@emissions.co.uk

May 31–June 11, 1999, Bonn, Germany

UNFCCC Subsidiary Body Meetings (SBSTA, SBI), organized by the UNFCCC Secretariat

Contact: UNFCCC Secretariat, Bonn, Germany

Internet: <http://www.unfccc.de>

June 10–11, 1999, Hamburg, Germany

Commercial Opportunities in Emissions Trading, organized by International Power Generation/DMG Business Media

Contact: Julia Russell, Development Manager, Conference Division, DMG Business Media, Surrey, UK

Tel: (44) 1737 855 450/768 611

Fax: (44) 1737 855 470

E-mail: jrussell@dmg.co.uk

June 16–18, 1999, Sydney, Australia

Profitable Corporate Management of Climate Change Reforms, organized by IIR Conferences

Contact: Connie Kirk, Senior Conference Manager

Tel: (61) 2 9923 500 Fax: (61) 2 9959 4835

E-mail: info@iir.com.au

⁸ FCCC/CP/1998/2



Project eligibility criteria under the CDM

by Dean Anderson

Dean Anderson and Marina Ploutakinha's paper 'Defining CDM Baselines: Criteria and Interim Rules for Early Crediting' addresses essential aspects of CDM design. Its main points are the following:

- In order to establish a framework and starting point for rule-making for such factors as additionality criteria, baseline-setting methods, sustainable development criteria, and the functions of operational entities, the subsidiary bodies should first establish a broad set of principles and guidelines to govern CDM activities during the interim phase. These should, *inter alia*, clarify the extent to which the CDM is to be a multilateral institution (such as a fund) versus a regulatory regime, the roles and responsibilities of sponsor country and host country governments in project certification, the ongoing functions of the CDM governing body (Executive Board, if constituted, or other UNFCCC entity) and, most importantly, the objectives of the interim phase with respect to informing the COP of future efforts to elaborate permanent rules. Given the sensitivities of these matters, the subsidiary bodies would show satisfactory progress toward CDM implementation if they are able, during 1999, to propose a set of coherent principles and guidelines to COP5.
- Assuming that COP5 is able to agree on principles and guidelines, and is also able to give clear instructions to its subsidiary bodies with respect to the rules needed to allow projects to go forward, the subsidiary bodies should be able, by COP6 in 2000, to develop a set of interim rules that will ensure that CDM projects undertaken in 2001 deliver real emission offsets and meet the standards for sustainable development established by the rules. (An example of an appropriate rule is that offset credits shall only be issued to a project sponsor *ex post*, i.e. based on certification that the offset was actually achieved).
- Rule-making can and should apply to additionality criteria. Several methods

are potentially credible depending on the type of project being considered and the institutional capacities of the host country government. Countries able and willing to set top-down baselines by aggregating national or sectoral data should be encouraged to do so. However, it is unrealistic to think that many countries will be in this position during the interim phase. It will be necessary to use bottom-up methods in most cases. However, this should not be viewed as a 'compromise' situation. Bottom-up (project-by-project) baselines have methodological advantages for some project types, and they can be applied conservatively to ensure that credits are only issued for certified *real* offsets. Method-based approaches, such as benchmarking, should also be allowed, though realistically the advantages they offer in terms of streamlining and standardizing baseline setting compared to project-level baselines are not likely to be realized until after the interim phase, when hundreds or thousands of projects are in the pipeline.

- There are two possible approaches to project permitting/certification. The first would be for an international (UNFCCC) body, perhaps the CDM Executive Board, or a commission operating under its or the COP's supervision, to be responsible for certifying individual projects. This commission would share responsibility with respective host country governments for determining a project's compliance with sustainable development standards. The COP should set guidelines establishing whether host governments alone, or such governments in consultation with an international commission, should approve projects with respect to their satisfaction of the sustainable development criteria. However, with respect to meeting additionality criteria, primary responsibility must rest with the international commission. The second, alternative, approach to having an international project

permitting/certification board would be to delegate this responsibility to accredited operational entities, such as existing certification firms operating under international and national laws and rules. The latter approach may be the only viable approach after the interim phase when hundreds or thousands of new projects are being proposed each year. However, in the interim phase, an international commission under the UNFCCC might be able to manage the flow of project applications without becoming a bottleneck. And the commission's 'learning-by-doing' might enable it to provide valuable input to the COP elaboration of permanent rules.

Some of the issues surrounding the development of rules governing a possible interim CDM phase are:

- Whether and how to apply an additionality test to proposed projects. Such a test would be used as a preliminary screening tool.
- Which baseline methodologies to allow (for the purpose of quantifying additionality). The options are: (1) top-down approaches (national or sectoral baselines based on aggregated data); method-based approaches—such as benchmarks, performance standards, and/or technology matrices; or the bottom-up approach, which involves establishing project-level baselines.
- Which entities to assign responsibility for certifying projects *a priori* and for certifying emission reductions/offsets *ex post*. Options are: (1) operational entities accredited by a COP subsidiary body or the CDM Executive Board, if constituted (operational entities could be either private firms, public agencies, or a combination of the two); and (2) a special-purpose international institution operating under the authority of the COP or CDM Executive Board. Such an institution would have to coordinate its deliberations and decisions with sponsor and host country governments.
- Whether to have separate or combined



permitting/certification procedures for the emissions reduction dimension of a CDM project, on the one hand, and the sustainable development dimension of the project, on the other. A number of developing countries argue that host country governments should have sole responsibility for determining a project's compliance with (its) sustainable development criteria. Other countries and some analysts argue that an international institution under the authority of the COP or, alternatively, operational entities accredited by the COP, should share such responsibility with host country governments in order to ensure that universally accepted international standards are met.

- Whether CDM governance should be restricted to regulation or combine regulatory functions with those of a fund. If the 'fund model' is preferred, whether the fund should be a project pool, investment pool, emission reduction credits pool, or a

combination of these. (The Prototype Carbon Fund proposed by the World Bank would pool investment funds and projects). Also, whether the fund should insure investments/credits and whether the fund should allocate investment quotas to countries or regions (such as Africa).

- How to operationalize the requirements of Article 12 that the CDM use a share of the proceeds from certified project activities to cover administrative expenses as well as to assist developing countries particularly vulnerable to the adverse effects of climate to meet the costs of adaptation.
- Which project types to allow to receive credits. Some delegations and observers think all project types, including all types of land-use change and forestry (LUCF) projects, should be included in the interim phase in order to foster learning by doing. They argue that this will assist the COP to elaborate sound permanent rules, and

it will avoid discrimination. Others think only certain project types should be eligible for crediting during the interim phase. Some would disqualify all or most LUCF project types on grounds that emission offsets from sink projects pose too many quantification uncertainties, and/or leakage problems, and/or doubts regarding the permanency of offsets. Others would disqualify certain types of LUCF projects on the grounds that they do not fit within the categories of activities stipulated in Article 3.3 (afforestation, reforestation, and deforestation). Still others would wait for the conclusions of the IPCC special report before deciding which types of LUCF projects to allow. Some delegations and observers, including the environmental NGOs, would restrict crediting to a limited list of project types that they regard as more clearly additional by definition, such as projects introducing truly clean, cutting-edge technologies.

- Article 12.10 of the Kyoto Protocol states: 'Certified emission reductions obtained during the period from the year 2000 up to the beginning of the first commitment period can be used to assist in achieving compliance in the first commitment period'. However, most observers agree that credits earned by project sponsors could only be applied to sponsor-country Assigned Amounts after the sponsor country has ratified the Protocol.

Dean Anderson is Senior Economist, ECON, Oslo.

BP Amoco's pilot CO₂ emissions trading system

The objectives:

- To develop a cost effective mechanism for the reduction of greenhouse gas emissions within BP Amoco;
- To demonstrate BP Amoco's commitment to tackle climate change and its emissions profile;
- To gain experience for BP Amoco in emissions trading; and
- To provide practical input into the design of future national and international emissions trading systems.

Design features:

- Twelve business units (BUs) out of 90 worldwide were selected to participate in the pilot. These represented BP Amoco's exploration, refining and chemicals businesses and are based in the US, Europe, and Australia; together they account for 25 per cent of BP Amoco's CO₂ emissions. Two units from developing countries were included in the pilot as observers.
- Each BU has received a basic allocation of emission rights for 1999 through to 2003.
- Allocations are consistent with the overall BP Amoco target for CO₂ emissions.

- All BUs will have to ensure emissions are within allowable limits in each annual compliance period—plus or minus purchases or sales of rights; there will be penalties for non-compliance.
- BUs will be able to bank allowances unused at the end of the year for future use, but they will not be allowed to borrow from future year's allocations.
- Trades will be denominated in carbon dioxide equivalent units. The system will start with CO₂ but will aim to include methane.
- Trades will normally be conducted through the broker, located in BP Amoco's oil trading arm. All trades will have to be registered with the broker.
- Environmental performance will be externally audited and results will be publicly reported each year.
- More BUs will be able to opt-in as the system progresses.

The BP pilot emissions trading system was developed in partnership with the Environmental Defense Fund (EDF), a major US-based environmental NGO.

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can be obtained free of charge from:

**UNCTAD Secretariat
Greenhouse Gas Emissions Trading Project
Palais des Nations, 1211 Geneva 10, Switzerland**

For further information, contact:

**Frank Joshua
Tel: (41 22) 917 5834/5831 Fax: (41 22) 907 0274
e-mail: frank.joshua@unctad.org**

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