

## Chapter 5

# Deciding on EU Emissions Trading

In this chapter, we narrow in on the decision-making phase of the EU Emissions Trading Scheme. This phase ran from 2001 to the adoption of the ET Directive in 2003 and the Linking Directive in 2004, which linked the EU ETS to international flexible mechanisms. The main question here is to what extent – and why – the member-states, the EU institutions and the climate regime affected the design and adoption of the EU ETS.

We examine three propositions derived from three explanatory approaches: intergovernmentalism, multi-level governance and regime analysis. The first proposition focuses on the position of the member-states, and holds that the EU ETS reflects the interests and preferences of the member-states. The second proposition stipulates that the EU ETS reflects the positions of the EU institutions, rather than the positions of the member-states. Finally, we propose that the EU ETS is more a result of external than internal driving forces. In line with this assumption, we would expect the EU ETS to reflect developments within the climate regime and the international emissions trading system rather than internal processes.

### **Positions of the EU Member-states**

As noted in Chapter 3, the key elements of the ET directive proposed by the European Commission in October 2001 remained intact during the negotiations that led up to the adoption of the ET Directive in October 2003, despite some design changes. In line with our proposition that the EU ETS came to reflect the positions of the member-states, this suggests that they agreed to the Commission proposal. The reason could be either that they had changed their preferences from the consultation process on the Green Paper, when only a slight majority supported emissions trading and key countries such as France and Germany were reluctant – or that various member-state interests were taken into account by the Commission in its ET directive proposal. The main question to be explored here is thus the extent to which and how the common position and the final ET Directive reflected the interests and preferences of the EU member-states.

### *Proposing the ET Directive*

Did the interests and preferences of the member-states change from the Green Paper to the ET directive proposal? In January 2001, DG Environment started to draft the ET directive on the basis of significantly diverging member-state positions. Less

than a year before, member-state responses to the Green Paper on emissions trading had showed that there were few areas of common understanding as to what an ETS should look like (see Chapter 4). An ET directive proposal was planned before the resumed CoP-6 in Bonn in July. DG Environment finished the draft proposal in May and forwarded it to other DGs for interservice consultations. However, Environmental Commissioner Margot Wallström decided to postpone the proposal due to opposition from several industry lobby groups.

A new round of consultation with industry, ENGOs and member-states (plus the European Economic Area (EEA) and accession countries) was convened on 4 and 10 September respectively. The consultation meeting with the member-states was structured by the presentation of key questions prepared by the climate change unit in DG Environment and based on the widely-leaked draft proposal.<sup>1</sup> All invited stakeholders attended the meeting: 16 representatives from the Commission representing six different DGs, representatives from all member-states and most EEA and accession countries. The minutes from the meeting indicate a significant change in member-state positions towards convergence around a common EU ETS, compared to the responses to the earlier Green Paper.<sup>2</sup>

First, everyone supported the development of an emissions trading framework at EU level, and many member-states emphasized that national level schemes were not attractive. Second, the overwhelming majority favoured a system common to certain sectors based on a core harmonized list of activities. Third, there was general agreement that allowances should be allocated by the member-states within the constraints of the Burden-sharing Agreement. Fourth, there was widespread agreement that there should be a common method for allocation of allowances. Finally, a large majority supported common monitoring, reporting and verification standards and harmonized penalties for non-compliance. The reasons for the latter provision, which received strong support, were the market nature of emissions trading and single-market considerations (Meadows 2006, 92).

Despite the agreement on the main structure of the proposed scheme, disagreement surfaced on some important design elements. Most importantly, there was disagreement on the legal nature of the scheme in the pre-2008 period. Some – particularly the UK, Germany and Finland – preferred an initial phase based on a voluntary scheme; others preferred a mandatory scheme. Second, there was no clear convergence around whether allocations should be based on payment (auctioning), be free (grandfathering) or a combination. Although a majority preferred allocation for free, a smaller group, led by Sweden, argued consistently for auctioning (Vis 2006b, 190). Third, some preferred that the common list of sectors could be extended voluntarily by member-states ('opt-in'), whereas others preferred a harmonized way

1 *ENDS Daily* (25 June 2001), 'EU Climate Trading Scheme Set to Emerge', Issue 1016.

2 To our knowledge, there is no official record from this meeting with the member-states. However, there is a draft summary record that gives the thrust of the main conclusions. European Commission (8 October 2001) Directorate General Environment Climate Change: Chairman's Summary Record of Consultation Meeting with Member-States, EEA and Accession Countries. 10 September 2001. Brussels.

of extension. Finally, positions varied on whether penalties should be based on only a common underpinning, or full harmonization.

Germany's federal government, which had not expressed its position on the 2000 Green Paper, submitted its position paper to the European Commission on 10 September. Germany emphasized the effectiveness of the national voluntary climate agreements and proposed a pilot phase with voluntary participation for both companies and member-states (Watanabe 2005). The German Emissions Trading Group (AG Emissionhandel, AGE), with broad-based participation from ministries, industry and ENGOs, was also invited to the stakeholder consultations in September, where it submitted a separate position paper. After intense negotiations, the group submitted a compromise position paper along the same lines as the federal government, arguing for a three-year pilot phase with voluntary participation. The position of the AGE was based on a compromise between industries that preferred to continue with the voluntary climate agreements and a few large companies that favoured emissions trading. These position papers showed that Germany was struggling to speak with one voice, as internal disagreement would weaken its negotiating position in the Council. At this stage, Germany did not reject any form of emissions trading at EU level, but Germany's opposition to mandatory participation in the first phase of the scheme appeared quite robust.

Despite Germany's opposition to mandatory participation, the consultation meeting with the country representatives was described by the Commission as relatively 'easy' compared to the meeting with industry and ENGOs.<sup>3</sup> Many member-state representatives were passive, and the meeting was marked by significantly less disagreement than with the non-state actors. One reason may be that the member-states would have better opportunities to express their views later in the Council of Ministers on the basis of a formal ET directive proposal. Or something may have changed that helped to unify the positions of the member-states. Besides a steady increase in knowledge on emissions trading (particularly among those member-states which had established domestic ET expert groups), the most significant change from the year 2000 to 2001 was external: it came with the US elections and President George Bush's rejection of the Kyoto Protocol in March 2001. This injected significant political energy into the climate policy of the EU and affected the collective will of its member-states, as discussed later in this chapter.

DG Environment presented a new draft ET directive to other Commission services shortly after the consultation meetings in September 2001.<sup>4</sup> The draft took a clear position on controversial aspects: the scheme should be binding in the pre-2008 phase; it should be based on allocation for free; and with common penalties for non-compliance. In addition, it included the possibility for member-states to temporarily exclude installations from the EU trading scheme. This 'opt-out' provision came as a result of pressure from industry, but was removed by Commissioner Wallström in

3 Interviews in Brussels, 15 May 2006.

4 European Commission (14 September 2001), Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC, (draft) version for interservice re-consultation (Brussels).

the final ET directive proposal. The final proposal for an ET directive was presented by the Commission to the European Parliament and the Council in October 2001.<sup>5</sup>

As noted in Chapter 3, the final proposal was more decentralized than had been indicated by the Commission in the 2000 Green Paper. First and most importantly, allocation of allowances should be done at the member-state level and not at Community level. This was preferred by a majority of the member-states.<sup>6</sup> Second, allocation should be free of charge – also preferred by a majority of the member-states and most industries. Third, member-states could decide on whether to use independent verifiers of emissions, or do it themselves. Together, this shows that the basic positions of the member-states were taken into account in the proposal for a directive on emissions trading. This means that a combination of change in positions and influence by the member-states on the proposed ET legislation made an imprint even before the formal decision-making process started.

### *Responses to the ET Proposal*

Despite draft proposals and consultation meetings, the formal proposal for an ET directive came as a surprise to some member-states. In Sweden, for example, decision-makers were both concerned and fascinated by this new instrument.<sup>7</sup> Concerned, because the implications of the proposal were uncertain; fascinated, because the ET directive proposal represented a new and radical way of dealing with greenhouse gas emissions.

The proposal for an EU directive on emissions trading was adopted by the Commission on 23 October 2001. At the Environmental Council meeting shortly after, the Council noted that it was 'appreciative to the Commission for presenting a proposal for a framework directive for an EU greenhouse gas emissions trading scheme'.<sup>8</sup> The first debate on the proposed ET directive took place in the Environment Council on 12 December 2001, where the Belgian Presidency submitted the following key questions to structure the discussion:<sup>9</sup> (1) should the system be mandatory or voluntary in the initial phase (2005–07)? (2) which allocation method should be used and should it be harmonized for all commitment periods? and (3) as to coverage: should the directive initially cover CO<sub>2</sub> alone? Could member-states freely add other sectors? Should emissions from the electricity generation sector be

5 European Commission (23 October 2001), COM(2001)581, Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC (Brussels).

6 A smaller group of member-states led by France and Belgium preferred a greater degree of harmonization (Vis 2006b, 188).

7 Interview with Ulf Sviden, 1 March 2006.

8 Council (29 October 2001), 12994/01, 2378<sup>th</sup> Council Meeting Environment. Presse-372, 2001. Luxembourg, 7.

9 Council (6 December 2001), 15028/01, Report from Permanent Representatives Committee to Council. Questions prepared for policy debate on the EU ETS in Council (Environment) of 12 December 2001. Brussels.

credited to the consumer or the producer? These questions originated from the points of disagreement at the September 2001 consultation meeting.

Not surprisingly, the legal nature of the scheme triggered most disagreement. A majority of the member-states favoured a mandatory system. These countries argued that a mandatory scheme would ensure participation by affected industries and be least likely to distort competition.<sup>10</sup> At this stage, the opponents formed a blocking minority, according to the Belgian environment minister who chaired the meeting.<sup>11</sup> The opposition was led by Germany and the UK. For the UK, this issue was important, since its own domestic ET scheme was planned to be voluntary until 2007. In the case of Germany, the main source of opposition came from industry, where it was feared that the EU ET scheme could lead to higher abatement costs than the German voluntary climate agreements. It was already clear that Germany and the UK would become two of the most important participants in the scheme – in fact, they came to represent 34.0 per cent of the total amount of allowances distributed by all the 25 member-states for the first trading period, 2005 to 2007 (see Table 3.2).

The proposal for an ET directive was based on Article 175(1) and the co-decision procedure set out in Article 251 of the European Community Treaty. This legal basis provides for qualified majority voting in the Council and allows member-states to be outvoted (and the European Parliament to veto the proposal). The legal base chosen was the first line of defence by those most in opposition to the Commission proposal. They preferred Article 175(2), which can be used if measures are fiscal or significantly affect member-state's choice of energy sources. If Article 175(2) had been chosen, the proposed ET directive would need to be adopted unanimously, a factor which led the energy/carbon tax to fail. Unanimity would have increased the influence of each member-state on the system, but reduced the likelihood that all would agree on the same system. In essence, unanimity would increase the risk of deadlock. At the Environment Council meeting in March 2002, the ministers adopted a legal instrument obliging the member-states to ratify the Kyoto Protocol. The legislation was proposed on the basis of qualified majority, even though some states argued that the law concerned energy policy, which requires unanimity. The Commission worried that changing the legal base could provide a precedent for similar changes in relation to the ET Directive.<sup>12</sup> Shortly after, however, it was settled that Article 175(1) would be the legal base because the proposal did not, according to EJC case law, satisfy the conditions for 175 (2) (Meadows 2006, 65).

Unanimity would have provided Germany and the UK with veto power over the proposed ET directive. This would most likely have resulted in a voluntary ET scheme or no EU ETS at all – as in the case of the EU carbon/energy tax. If a legislative proposal is significantly weakened by its opponents there is a risk that

10 Council (12 December 2001), 15060/01, 2399<sup>th</sup> Council Meeting Environment. Presse-459, 2001. Brussels.

11 *ENDS Daily* (13 December 2001), 'EU States Divided Over Climate Emission Trading', Issue 1123.

12 *ENDS Daily* (4 March 2002), 'EU Gives Green Light to Kyoto Ratification', Issue 1170.

initial supporters may turn into opposition. However, as noted in Chapter 2, in the Council there is a norm of consensus-seeking and unanimity, despite the possibility of qualified majority is allowed for. This norm was particularly strong in the case of the ET Directive, as this was a totally new policy instrument with potentially significant economic implications for energy producers and energy-intensive industry. It was therefore important to get the directive adopted by unanimity.

In practice, the ET Directive would not work well without the support of Germany as the largest emitter within the European Union. Although the final number of installations to be covered by each country in the system was not known at this stage, it was, as noted, already clear that German industry would represent a significant share of the EU emissions trading market. UK support was also substantially and politically important. Besides representing a significant amount of the relevant emissions within the EU ETS, the UK had supported the idea of emissions trading all the way. Political weight and control over a significant share of the sources covered by the ET system provided these countries with more power in the decision-making process than the qualified majority procedure would suggest.

The other elements of the debate in the Council were less divisive.<sup>13</sup> A vast majority of the member-states held that allocation of allowances should be free of charge so as to stimulate participation, and that the method of allocation should be harmonized and based on harmonized criteria to prevent distortion of competition. With regard to coverage, there was broad support for starting with CO<sub>2</sub> and the sectors proposed by the Commission. However, a few wanted to include additional sectors on a voluntary basis, while others stressed that criteria for expansion should be harmonized at Community level. Finally, a large majority preferred that the costs should be borne by the electricity producers, in line with the 'polluter pays' principle. The President concluded by noting that: '... positions were not firmly fixed, since consultations were still under way in some member-states, which had therefore expressed preliminary views. ... many states were keeping an open mind and that positions could therefore change ...'.<sup>14</sup>

*Germany* The discussion intensified and became polarized in Germany after the ET directive proposal in October 2001. Mandatory participation was clearly not acceptable for most industries and governmental ministries and agencies. The strongest opponents included powerful industrial associations like the Federation of German Industries (BDI – Bundesverband Deutscher Industrie) and the Chemical Industry Association (VCI). These associations and major companies lobbied intensively against the ET directive proposal: they hired consultants to denounce the proposal, they sent letters to Chancellor Schröder requesting him to reject it, and the VCI placed full-page announcements in German newsmagazines stating that emissions trading would stifle investments and economic growth in Germany. And indeed, in response the Chancellor publicly voiced opposition to the ET directive proposal (Butzengeiger et al. 2003; Michaelowa et al. 2005).

<sup>13</sup> Council (12 December 2001), 15060/01, 2399th Council Meeting Environment. Presse-459, 2001. Brussels.

<sup>14</sup> Ibid., 14.

Support for the proposal was forthcoming from only a few big companies, including subsidiaries of BP, Shell and to some extent the Hamburg Electricity Utility (HEW). According to Michaelowa et al. (ibid., 112), emission trading gained surprisingly little public support. On the other hand, an independent study showed that the big industrial federations were not necessarily as representative as they claimed to be. A survey of a sample of German energy intensive industry showed, among other things, that: (1) the level of knowledge on emission trading was very limited; (2) most companies did not anticipate that emissions trading would represent a significant cost-burden on their business (Santarius and Ott 2002).

In light of the opposition from German industry and the support from a majority of the EU member-states, the German Ministry of the Environment (BMU), which supported the ET directive proposal, and the Ministry of Economics and Labour (BMWA), which opposed it, agreed on a common negotiation strategy (Watanabe 2005). This strategy was based on Germany's official position as demonstrated in autumn 2001; it aimed at influencing the design of the scheme in a way that would allow Germany to continue with the voluntary approach – not to oppose the proposal in itself. The main elements of the strategy were voluntary participation and opt-out (Watanabe and Mez 2004). A voluntary scheme would allow countries, sectors or installations to decide whether to participate in the EU ETS or not. Opt-out allows for exclusion from a mandatory scheme by fulfilling certain conditions. This strategy was also supported by German MEPs at the first reading of the European Parliament in October 2002, showing that German industry had successfully lobbied the MEPs. As noted in Chapter 3, however, the final EU ET Directive did not conform with Germany's preferences. The scheme finally adopted was mandatory and with very limited opt-out.

The mismatch between Germany's negotiating position and the final outcome indicates that Germany had to give in. Despite the country's political and substantial negotiating power, the intense rivalry within Germany weakened its negotiating position and influence in the Council. With the qualified majority decision rule settled early in the negotiations and pressure from a majority of the member-states, Germany faced an uphill battle. On the other hand, it might be that Germany changed its position as a result of the federal elections held shortly before the Council agreed on a common position in December 2002.

The coalition between the Social Democratic Party (SPD) and the Green Party had been in power since 1998. Before the federal elections of 22 September 2002, Environment Minister Trittin, with some Greens, and parts of the SPD supported the proposed ET directive, while the leader of the coalition government, Chancellor Schröder, opposed it. The conservative opposition, led by Edmund Stoiber (the Christian Democratic Union, CDU, the Christian Social Union, CSU, and the Free Democratic Party), apparently opposed the proposed directive (Watanabe 2005). The conservatives were widely expected to win the election due to economic recession and increase in unemployment.

Disastrous flooding of the Elbe and Danube rivers in August placed environmental issues at the top of the election agenda and led to a boost in the polls for the SPD-



Green coalition government.<sup>15</sup> The extreme weather events – causing thousands of human injuries and significant economic damage – were also picked up by the EU Environment Council and linked to climate science predictions that such events would become more frequent and intense.<sup>16</sup> This situation was exploited by the SPD, which accused Stoiber of failing to state his position on climate change and other environmental issues, and failing to nominate an environmental minister if the CDU/CSU coalition should win.<sup>17</sup> With the help of environmental issues, a second term was secured for the coalition government. The Greens entered the coalition talks in a stronger position than in 1998. The party polled 8.6 per cent of the vote (55 seats in parliament), up from 6.7 per cent (and 47 seats) in 1998.<sup>18</sup> This would most likely strengthen environmental policies in the new coalition government.

The coalition agreement was published on 16 October 2002. Here, the SPD-Green coalition accepted the proposed ET directive subject to certain conditions, including: measures taken since 1990 to reduce emissions of greenhouse gases in Germany must be taken into account; allocation of permits must be free of charge; use must be made of flexible instruments under the Kyoto Protocol; and most importantly: the scheme must be run in conjunction with the voluntary agreements, for example in the case of mandatory trading pools.<sup>19</sup> According to Vis (2006b, 190), the coalition agreement sealed the situation whether auctioning was going to be a choice for the member-states initially. The purpose of mandatory pooling was to allow the government to decide on participation in the pool with the aim of maintaining the voluntary climate agreements. This means that Germany had abandoned its opposition to a mandatory scheme, but argued for mandatory pooling which would make the ET Directive compatible with the voluntary climate agreements. Even though Germany accepted EU emissions trading in the coalition agreement, it shows that Germany had not changed its position before the adoption of the common position among the member-states in the Council: compatibility between an EU ETS and the German voluntary climate agreement.

Discussions in the Council had to be postponed due to negotiations with Germany, which tried to influence the proposed EU directive right up until the common position was adopted in December 2002 (Lefevre 2005, 101). This is reflected in the ambiguity of the conclusions at the Environment Council meeting in October 2002: 'The Council welcomes its political agreement reached today on the Directive ... establishing a scheme for greenhouse gas emission allowance trading within the Community and ... emphasizes the will of all Member-states to reach a political

<sup>15</sup> *ENDS Daily* (30 August 2002), 'Stoiber Strives to Recover the Green Initiative', Issue 1276.

<sup>16</sup> Council (17 October 2002), 12976/02, 2457<sup>th</sup> Council Meeting Environment. Presse-320, 2002. Luxembourg.

<sup>17</sup> *ENDS Daily* (15 August 2002), 'Green Issues in German Election Spotlight', Issue 1269.

<sup>18</sup> *ENDS Daily* (23 September 2002), 'Germany's Greens Stroll Back into Power', Issue 1292.

<sup>19</sup> *ENDS Daily* (27 November 2002), 'Germany Digs in over EU Emission Trading Plans', Issue 1338; Watanabe 2005.

agreement as soon as possible and at the latest at the December Council'.<sup>20</sup> As late as in November, Federal Minister of Economics Wolfgang Clement stated: 'emissions trading as proposed by the EU needs a critical look in the light of the exemplary way industry and energy firms have approached emissions cuts obligations for 2012 ... German industry's voluntary agreements must be taken into account'.<sup>21</sup>

Despite Germany's insistence on continuing with the voluntary agreements in one way or another, it was able to influence the final directive only to a very limited extent. A mandatory emission trading scheme was agreed by all member-states in the common position adopted by the Environment Council in December 2002.<sup>22</sup> The core elements of the scheme included its binding nature, the compulsory listing of the sectors of activity to be covered, the initial focus on CO<sub>2</sub> only, and the emphasis on harmonized rules for allocating emission allowances and adequate monitoring, reporting, and verification of emissions, as well as penalty for non-compliance. The first phase of the scheme covers the period between 2005 and 2007, which precedes the Kyoto Protocol's first commitment period from 2008 to 2012 corresponding to the second phase of the scheme. All this was in line with the proposed directive.

The Council's political agreement also shows that the member-states were able to affect the outcome. The agreement provided member-states with:

- the possibility to apply to the Commission for temporary exclusions of certain installations and activities until 31 December 2007 (opt-out);
- the possibility of unilateral additions of certain activities and gases from 2008 (opt-in);
- free-of-charge allocation of allowances for the first phase and at least 90 per cent free-of-charge allocation in the second phase, thereby making the use of some auctioning possible for member-states who choose to do so;
- 'pooling of installations': member-states may allow operators carrying the same activity to voluntarily form a 'pool' and nominate a trustee responsible for managing the allowances on their behalf;
- adjustment of penalties to operators – €40 in the first phase and €100 in the second phase for each extra tonne of carbon dioxide emitted and not covered by sufficient allowances.

The main concession given to Germany for its acceptance of a mandatory scheme was the 'pooling' provision, which ended up as a new Article 28 in the ET Directive. As noted, Germany proposed the inclusion of a provision that would permit sectors or all industry to pool their allowances and allow the German government, as a trustee, to manage the pool. Participation in the pool should be mandatory for the sectors participating in EU ETS. This proposal would imply that no emission trading would take place within Germany: it would have taken the system from the level

<sup>20</sup> Council (17 October 2002), 12976/02, 2457<sup>th</sup> Council Meeting Environment. Presse-320, 2002. Luxembourg, 18.

<sup>21</sup> *ENDS Daily* (27 November 2002), 'Germany Digs in over EU Emission Trading Plans', Issue 1338; Watanabe 2005.

<sup>22</sup> Council (9 December 2002), 15101/02, 2473<sup>th</sup> Council Meeting Environment. Presse-379, 2002. Brussels, 7.

of installations to the state level, and German industry out of the emission trading market (Lefevre 2005, 104). According to Article 28, member-states may apply to the Commission to allow pools that are not mandatory. Moreover, if a trustee fails to comply with the penalties under the regime, 'each operator of an installation in the pool shall be responsible...in respect of emissions from its own installation'.<sup>23</sup> Article 28 weakened the pooling provisions to the extent that they have not proven popular in practice and it is unlikely that the provision will be extended (Lefevre 2005, 105; Meadows 2006, 111).<sup>24</sup> In essence, Germany had to accept an EU ETS that differed significantly from its own preferences.

*The UK* The UK was the other main opponent to a mandatory EU ETS, but for different reasons than Germany. The UK domestic ETS started as planned in April 2002 after 34 companies took on reduction targets at an auction in return for incentive payment.<sup>25</sup> The UK ETS would run to 2007, two years after the introduction of EU ETS. In November 2001, the European Commission cleared the UK plans while warning that there were substantial differences between the British and EU systems.<sup>26</sup> One key difference was that the British scheme was voluntary. Additional differences included financial incentives to companies to participate, exclusion of electricity and heat generators, and coverage of all six greenhouse gases. The UK's primary negotiation strategy was to persuade the Commission to develop the EU ETS in line with the British approach, but in this it was unsuccessful (NAO 2004). Like Germany, the UK then worked for a voluntary scheme which would allow for sufficient flexibility for the British scheme. In the end, however, the UK had to give in and support a mandatory EU ETS scheme – which in turn meant amending its existing voluntary trading scheme to fit in with the EU trading rules.

The concession made to the UK (and others) to ease the transition was the time-constrained opt-out provision in the common position set forth in a new Article 27 of the ET Directive on the temporary exclusion of certain installations (Lefevre 2005, 104).<sup>27</sup> As we shall see below, the European Parliament was able to change the scope of this provision from opt-out for both installations and activities, to installations only. For the first period of the EU ETS, the ET Directive allows for an opt-out at

<sup>23</sup> European Parliament (25 October 2003), Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and Amending Council Directive 96/61/EC, *Official Journal of the European Union* L 275, 32–46.

<sup>24</sup> Article 30(2)(j) provides for an assessment and possible change in the pooling clause.

<sup>25</sup> The UK scheme was immediately criticized for low environmental effectiveness. For example, it was argued that significant companies had already met their targets as a result of pollution control permit requirements. *ENDS Daily* (3 April 2002), "'Hot Air' Undermines UK Emission Trading Scheme', Issue 1188.

<sup>26</sup> *ENDS Daily* (28 November 2001), 'EU Gives Amber Light to UK Emission Trading', Issue 1112; Roeser and Jackson 2005.

<sup>27</sup> However, it was actually re-introduced by Germany in the Council (Meadows 2006, 108). Re-introduced, because it had been removed by the Commission in the final round of preparing for the ET directive proposal.

the request of an EU member-state. UK companies that wish to opt-out of the EU ETS can ask British authorities to put forward their request to the Commission.<sup>28</sup> Approval under this provision is subject to a range of conditions, including that the UK provides evidence that domestic climate change policies are as stringent as under the EU ETS. In the final negotiations on the common position, the UK's main objection to the proposed directive was that the Commission had the power to reject National Allocation Plans and applications to opt-out installations. The UK preferred a scheme that would leave application of the opt-out clause to the discretion of the member-states. However, the Commission retained the right of veto over NAPs, as per Article 9 of the ET Directive. As with the German pooling arrangement, the final opt-out provision is thus very limited. In practice, only three member-states have sought to use the opt-out clause: the UK, the Netherlands and Poland (Meadows 2006, 109).

A second concession was specified in the new Article 29 of the ET Directive. Here, governments were given the right to apply to the Commission for extra allowances during the first three years in *force majeure* circumstances. It would be up to the Commission to determine whether *force majeure* was demonstrated. Despite these limited concessions, which left the final word to the Commission, in essence also the UK had to accept a system significantly different from its preferences. This interpretation is reinforced by a report of the UK National Audit Office concluding that integration with the European Scheme would be difficult (NAO 2004).

Also other member-states had to adapt to the ET directive proposal. In February 2002, a multi-stakeholder Dutch panel recommended a national trading scheme. The Dutch trading commission was convened in mid-2000; it proposed a system close to the UK ETS.<sup>29</sup> In April, the Dutch cabinet agreed to reject the Dutch proposal and to proceed within the EU framework.<sup>30</sup> Some minor concessions were, however, given to other member-states. France, for example, had argued for a lower penalty for failing to meet the trading targets; the fine was reduced from €50 per tonne of CO<sub>2</sub> in the ET directive proposal to €40 in the final ET Directive.

*The Danish Presidency* As pointed out in Chapter 2, the EU Presidency can play an important role in crafting political solutions. On assuming the presidency in the summer of 2002, Denmark announced that climate policy and political agreement on the conditions for emissions trading were among the government's aims within the area of environmental policy (Danish Ministry of Foreign Affairs 2002, 20). Agreement on the common position of the ET Directive was originally scheduled for the October Environment Council meeting, but had to be postponed due to German resistance. The compromise between the proposed ET directive and the common position was based on a draft prepared by the Danish presidency, including trading pools and limited opt-out the three first years.<sup>31</sup> Denmark was in an exceptionally

<sup>28</sup> Germany also supported the opt-out clause.

<sup>29</sup> *ENDS Daily* (5 February 2002), 'Dutch CO<sub>2</sub> Trading System Proposed', Issue 1151.

<sup>30</sup> *ENDS Daily* (16 April 2002), 'Netherlands Backs CO<sub>2</sub> Emissions Trading', Issue 1197.

<sup>31</sup> *ENDS Daily* (9 December 2002), 'Ministers Agree EU Climate Gas Trading Scheme', Issue 1346.

good position to lead the negotiations, due to experience with its national emission trading system. As it turned out, the ET directive proposal was much closer to the Danish domestic ET system than the British one. The Danish system was mandatory; it included the power sector; and focused on CO<sub>2</sub> emissions only.

The role played by the Danish presidency in crafting the common position has been acknowledged as one important condition for the political agreement reached in December 2002.<sup>32</sup> First, the Danes had the will – they really wanted an EU emissions trading system that was close to the Danish domestic one. Second, the Danes had in-depth knowledge of the ET directive proposal. Third, the Danish representatives were able to establish good relations with other countries and the Commission. Fourth, the Danes knew Brussels well and they knew that the Ministers could manage to deal successfully with only a limited number of outstanding issues. In the summer of 2002, three main important issues remained: whether the system should be mandatory of voluntary, coverage (scope of application), and how rights to pollute should be allocated.<sup>33</sup> In a background note submitted prior to the December negotiations, the Danish presidency took for granted the binding nature, compulsory listing of sectors and the initial focus on CO<sub>2</sub>, and listed four issues as open to debate:<sup>34</sup>

- temporary exclusion of certain installations and activities;
- unilateral addition of certain installations and gases;
- the method for allocation in the second phase;
- pooling of installations.

The Danish strategy thus appears to have been to focus on the big issues of disagreement, given a binding system. Before Denmark, Spain held the EU Presidency (January–June 2002), with Greece coming after Denmark (January–June 2003). These countries did not push for an EU ETS and would probably not have managed to craft a solution in the autumn of 2002.<sup>35</sup>

The decision-making process on the proposed ET directive should also be seen in light of rising emission trends in the EU.<sup>36</sup> In April 2002, the European Environmental Agency published new greenhouse gas inventory figures showing a 0.3 per cent rise in total GHG emissions from 1990 to 2000. EU emissions from 1990 to 2000 were down by 3.5 per cent of the percentage point committed by Kyoto, which implied 0.5 points from target midway between 1990 (Kyoto protocol base year) and the 2008–12 compliance period. This trend continued in 2001, when overall emissions rose by one percentage point compared to 2000, and CO<sub>2</sub> emission rose by 1.6 percentage points.<sup>37</sup>

<sup>32</sup> Interviews in Brussels, 15 May 2006.

<sup>33</sup> Council (25 June 2002), 10013/02, 2439<sup>th</sup> Council Meeting Environment, Presse-180, 2002. Luxembourg.

<sup>34</sup> See The Danish EU Presidency, Background note on 'Environment', <[http://eu2002.dk/EU2002/news/news\\_read.asp?iInformationID=25642](http://eu2002.dk/EU2002/news/news_read.asp?iInformationID=25642)>.

<sup>35</sup> Interviews in Brussels, January 12 and May 15 2006.

<sup>36</sup> *ENDS Daily* (29 April 2002), 'EU Climate Emissions Take Wrong Turning', Issue 1206.

<sup>37</sup> *ENDS Daily* (6 May 2003), 'EU Greenhouse Emissions Up Again in 2001', Issue 1437.

### The Linking Directive

As noted in Chapter 3, the Commission proposed a linking directive only a few days after the Council of Ministers agreed on the main directive. The aim was to specify the link between the EU ETS and the Kyoto Protocol's flexible mechanisms Joint Implementation (JI) and the Clean Development Mechanism (CDM). During Council negotiations, several changes were made to the proposal: a quantitative cap on JI/CDM credits as a percentage of the total quantity of member-state allowances, that CDM could not be used until 2008 (timing), and that neither sinks nor nuclear power would be included as eligible projects. Hydropower projects were considered legitimate if they took account of environmental and social impacts (qualitative restrictions).

**Table 5.1 The Commission's proposal and the final Linking Directive**

	Quantitative cap	Qualitative restrictions	Timing
<b>Commission's proposal in July 2003</b>	Review of credit import at 6%, final cap at 'for example 8%'.	– No nuclear power. – No sinks till after 2012. – Hydro-projects would have to take account of 'environmental and social impacts'.	The Directive would be dependent on the Kyoto Protocol entering into force. Wait until 2008 before any credits could be used.
<b>Linking Directive adopted in October 2004</b>	No common cap. Limits to be set by each member-state.	– No nuclear power till after 2012. – No sinks till 2008. – Hydro-projects over 20MW would have to comply with World Commission of Dams rules.	No longer dependent on the Kyoto Protocol entering into force. CDM credits could be used from 2005.

*Sources:* European Commission (23 July 2003), COM (2003)403, Commission Proposal for a Directive of the European Parliament and of the Council amending the Directive establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms (Brussels). Available at <<http://www.climnet.org/pubs/PropDirectiveJICDM.pdf>> accessed 22 May 2007.

Most of the member-state work on the Linking Directive was conducted in the Working Party on the Environment,<sup>38</sup> where delegates gathered for discussions on the linking

<sup>38</sup> The Working Party on the Environment is one of many Council working parties (for more information on these, see for example Larsson 2003). Usually at least one official from

issue close to every second week, from the first meeting on 29 July onwards till early April 2004. The delegates seemed to have plenty to talk about. There were 'major concerns' about the form and content of the Commission's proposal: A majority wanted a link established from 2005 instead of 2008.<sup>39</sup> Similarly, a majority opposed a quantitative cap.<sup>40</sup> Germany and the Netherlands, however, argued in favour of the Commission's proposal on this issue, while the UK and later Austria wanted the cap set at installation level rather than at member-state level.<sup>41</sup>

As for the qualitative restrictions, delegates were more divided. Only France proposed that nuclear projects should be admitted, 'at least after 2012', while several states (particularly the southern ones) questioned the ban on sink credits.<sup>42</sup> On the hydro-provision, two separate coalitions formed; on one side Germany, which would eventually gain support from the Netherlands and Sweden, demanding stricter

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the ministry responsible for the matter in every member-state participates in such meetings. In the Working Party on the Environment, different participants join the meetings, depending on the agenda (*Ibid.*, 94).

<sup>39</sup> Council (25 September 2003), Note 12896/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms (Brussels: Council of the European Union, General Secretariat); Council (9 October 2003), Note 13377/03 regarding: Preparation for the Council (Environment) Meeting on 27 October 2003, Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Policy Debate. (Brussels: Council of the European Union, General Secretariat).

<sup>40</sup> *Ibid.*

<sup>41</sup> See, for instance: Council (23 December 2003), Note 16379/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms. (Brussels: Council of the European Union, Presidency/General Secretariat); and Council (13 February 2004), Report 6235/04 regarding: Preparation of the Council Meeting (Environment) on 2 March 2004, Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Progress Report. (Brussels: Council of the European Union, General Secretariat).

<sup>42</sup> Council (25 September 2003), Note 12896/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms (Brussels: Council of the European Union, General Secretariat); Council (9 October 2003), Note 13377/03 regarding: Preparation for the Council (Environment) Meeting on 27 October 2003, Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Policy Debate. (Brussels: Council of the European Union, General Secretariat).

wording and an explicit reference to the World Commission on Dams;<sup>43</sup> on the other side, France, Spain and Portugal, which opposed the German proposal.<sup>44</sup> They were eventually backed by Italy, Greece, Austria and Finland.<sup>45</sup>

Clearly, not all member-state positions could be heard in the negotiations. Still, during the informal trilogues<sup>46</sup> of spring 2004, member-states came to gain considerable acceptance for their demands, even on issues not backed by a majority. First of all, they got their way with the cap.<sup>47</sup> While the Parliament's rapporteur had suggested that the domestic action should constitute 'at least half of the reduction (...) effort made',<sup>48</sup> this was not included in the final wording, which simply stated that limits would be set by each member-state.<sup>49</sup> Second, demands for an early link

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<sup>43</sup> Council (6 February 2004), Note 5975/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms. (Brussels: Council of the European Union, General Secretariat).

<sup>44</sup> Council (21 November 2003), Note 15082/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Text (Brussels: Council of the European Union, Presidency/General Secretariat).

<sup>45</sup> Council (2 December 2003), Note 15475/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms (Brussels: Council of the European Union, Presidency/General Secretariat); and Council (23 December 2003), Note 16379/03 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms. (Brussels: Council of the European Union, Presidency/General Secretariat).

<sup>46</sup> Informal meetings with the Council Presidency, the Commission and the Parliament rapporteur. Council (4 March 2004), Note 6490/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Compromise Proposal. (Brussels: Council of the European Union, General Secretariat); and Council (26 March 2004), Working Document 7844/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Compromise Proposal (Brussels: Council of the European Union, General Secretariat).

<sup>47</sup> Council (31 March 2004), Working Document 7931/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms (Brussels: Council of the European Union, General Secretariat).

<sup>48</sup> *Ibid.*

<sup>49</sup> The member-states were also heard on the issue of conversion. The Commission had originally proposed that CDM and JI credits had to be converted into EU allowances before



also seemed to pay off.<sup>50</sup> And while the Parliament was eager to amend changes in the hydro-provisions, it was the German coalition that got its way with the final wording on this issue.<sup>51</sup>

Finally, the French demand for including nuclear projects yielded results – possibly because French opposition to the German hydro-proposal had been ignored. Their plea for allowing nuclear credits ‘at least after 2012,’ was heard, as the final directive excluded such credits only until 2012.<sup>52</sup> The southern states, which had voiced a proposition on including sinks, were heard to a lesser degree.<sup>53</sup> Their only gain was that possible inclusion of sinks for 2008–12 would be reconsidered in 2006. A majority of the member-states, along with the Parliament, had been against sinks altogether.<sup>54</sup>

All in all, the Linking Directive became noticeably marked by member-state interests. The changes in timing, the quantitative cap and partly qualitative restrictions can largely be credited to member-state demands.

### Conclusion

In this section we have seen, first, that after the 2000 Green Paper the member-states changed their preferences to increasing collective support for the 2001 ET

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they could be traded in the EU ETS. However, at the insistence of several member-states, led by the UK (see, for instance, Council (8 December 2003), Note 15673/03 regarding: Preparation for the Council Meeting (Environment) on 22 December 2003, Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Policy Debate. (Brussels: Council of the European Union, General Secretariat); and Council (4 March 2004), Note 6490/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Compromise Proposal (Brussels: Council of the European Union, General Secretariat) the conversion concept was removed. The final directive permitted direct use of credits.

<sup>50</sup> Council (31 March 2004), Working Document 7931/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms (Brussels: Council of the European Union, General Secretariat).

<sup>51</sup> The EP had proposed that ‘credits resulting from large hydro-electric power (...) should only be [accepted] if the project complies with the criteria and guidelines established by the World Commission on Dams.’ They also wanted the definition of ‘large’ to be set at 10 MW. The presidency's proposal was worded differently, and proposed setting the limit at 20 MW, both of which prevailed in the final directive.

<sup>52</sup> France, however, still voted against the final directive, wanting a swifter adoption for nuclear projects. *EU Energy* (23 April 2004), ‘EP Adopts Kyoto Emissions Linking Directive’, Issue 81.

<sup>53</sup> *ENDS Daily* (5 February 2004), ‘MEP Offers Businesses Kyoto Trading Incentive’.

<sup>54</sup> *Point Carbon* (19 February 2004), ‘Feature: Linking Directive Divides Member States’.

proposal. As this instrument was new, some states continued to adjust their positions in Council negotiations along with new information and increased understanding of the consequences of this policy instrument. Second, it shows that some basic design features favoured by the majority were included in the proposal at the outset. The most important of these was that the Commission proposed a decentralized system based on allocation of allowances at national level. Both these observations support the proposition that the EU ETS came to reflect the positions of the member-states to a significant degree. The negotiations on the Linking Directive also show that the member-states had significant impact on the cap and timing.

However, the third observation opens up for the possibility that supranational institutions have had an independent impact on decision-making. Although the UK and Germany were able to affect the final directive to some (limited) extent, they had to yield and accept the final directive, even though it differed significantly from their preferences for a voluntary system. As these two major countries represent one third of the whole EU market for allowances from 2005 to 2007, this impact is far from trivial. The main reason for this institutional effect is that the directive was proposed under the EU's co-decision procedure that required support by qualified majority. As a qualified majority supported the binding nature of the scheme, there was a real risk that Germany and the UK could be outvoted even though the directive was adopted by unanimity. This shows that the formal opportunity to vote by qualified majority created pressure to make concessions in the ‘shadow of the vote’ (see Chapter 2). In addition, particularly Germany's negotiating position appeared to have been weakened by internal rivalry and the Danish Presidency was able to develop a political solution that became acceptable to all member-states.

The line of reasoning above is based on an understanding of institutions as arenas, in this case determining how decisions are made – the decision procedure applied. In the next section, institutions will be understood as organizational actors.

### EU Institutions and Non-state Actors

In this section, we analyse the influence of the EU institutions in the decision-making phase. To what extent and how was the final ET Directive shaped by the European Parliament? What role did the Commission play in this process? As noted above, institutions will here be understood as organizational actors rather than arenas. We will also address the role of non-state actors and their relationship with the EU institutions. Above, we saw how member-states were able to make several imprints on the EU ETS, including the Linking Directive. However, at least four changes to the ET directive proposal are difficult to understand against the backdrop of the member-state perspective:

- Why was an option for more auctioning included in the final directive?
- Why were more restrictions on the member-states autonomy to allocate allowances included?
- Why did the opt-out provision exclude sectors or ‘activities’?

- Why was the chemical industry, which was included in the Green Paper, excluded from the EU ETS?

This perspective can also increase our understanding of the speedy decision-making process, with just two years between the Commission proposal and the directive's formal entry into law.

#### *The Commission and Non-state Actors*

At the end of January 2001, the Commission started drafting the directive proposal. At the same time, Working Group 1 on emissions trading under the European Climate Change Programme (ECCP) continued with representatives from industry, the green movement, the Commission and some member-states (see Chapter 4).<sup>55</sup> The WG1 meetings contributed to further knowledge and capacity-building among stakeholders. On the other hand, the minutes of the meetings show that this process ended on a split note on many design issues, and not with a clear input to the further proposal design process. This is hardly surprising, given the variation of actors and interests present. It is quite illustrative that Germany's resistance to a mandatory system popped up at a meeting in mid-March when representatives of the BDI strongly opposed a mandatory system.<sup>56</sup>

With the US rejection of the Kyoto Protocol in March 2001, the Commission significantly stepped up its work on bringing out a proposal. Environment Commissioner Wallström felt that it was important for the Community to give a clear signal to the outside world that it was still taking the Kyoto Protocol seriously. The Climate Change Unit was instructed to prepare a draft proposal for adoption by the Commission before the start of the international climate change meeting in Bonn in mid-July. The draft proposal of the EU ET directive was sent to other Commission services for informal consultation in mid-May 2001 and went to interservice consultations at the end of May. This draft proposed a mandatory but still rather decentralized system, with allowance quantities mainly determined by the member-states. Sectoral and GHG coverage was in line with proposals in the Green Paper, except that the chemicals sector had now been excluded. Member-states would be able to propose other sectors for inclusion in the system ('opt-in'). Furthermore, as long as allocations complied with state aid rules, member-states would be free to choose the method of allocation – which potentially opened the way for the auctioning of allowances, as per the Green Paper. The penalty level for non-compliance was set at €200 for every excess tonne of CO<sub>2</sub> emitted – and that was ten times the allowance price anticipated by the Commission.<sup>57</sup>

<sup>55</sup> The 7th and 8th ECCP WG1 meeting were held on 14 February and 14 March. The final ordinary WG1 meetings were then held on 4 April and 2 May.

<sup>56</sup> European Commission (15 March 2001), ECCP Working Group 1, Summary Record of Meeting February 14 2001 (Brussels), 2.

<sup>57</sup> *ENDS Daily* (25 June 2001), 'EU Climate Trading Scheme Set to Emerge', Issue 1016; Reuters/Planetark (25 June 2001), 'EU Drafts Ambitious Emissions Trade Plan'.

Up to this point there had not been very much ETS disagreement within the Commission.<sup>58</sup> But this proposal was widely leaked, caused considerable uproar among industrial lobby groups who had anticipated another round of stakeholder consultations before a final proposal would be presented. Industry then did some heavy lobbying of the Commission, to delay adoption of the proposal (Lefevre 2005). Several commissioners, including DG Enterprise Commissioner Liikanen and DG Competition Commissioner Monti, blocked the proposal.<sup>59</sup> So, at the end of June, the Environment Commissioner decided to postpone the ET proposal until October at the earliest. The Commissioner had hoped to bolster the EU's position at the up-coming Bonn UNFCCC meeting on implementation rules for the Kyoto Protocol. Explaining the opposition from industry, UNICE's Cloquet stated: 'you can't jump from a green paper to a technical proposal without a proper consultation with those supposed to implement'.<sup>60</sup> There was uncertainty as to the method of allowance allocation, and worries in DG Competition that market distortions might emanate from the decentralized approach put forward in the draft proposal.<sup>61</sup>

The final report of the ECCP WG 1 was then presented at an ECCP Conference in July 2001. The group was now unanimous on the need to introduce emissions trading as soon as practicable. However, differences of opinion remained on such key design issues as whether participation should be mandatory or voluntary, and whether allocations should be 'indirect' or 'direct'. The latter is particularly relevant for whether allocation and monitoring among electricity producers should be based on emissions from particular installations, or should take into account emissions from electricity consumed by a country or installation.<sup>62</sup> The UK, which participated in the ECCP WG 1, favoured an indirect approach in line with its domestic ETS. There was also some disagreement on whether the system should be based on trading between member-states or companies, and on the role of relative versus absolute targets. From a GHG emissions perspective, the relative target approach ('baseline and credit') is more vulnerable to production growth than absolute targets (see Chapter 2). If there was going to be emissions trading, the relative target approach was strongly preferred by the chemical industry, which was represented in WG 1 by the European Chemical Industry Council (CEFIC) (see Table 4.1).<sup>63</sup> The group agreed on several recommendations that reflected differences of opinion among the participants. For example, 'Absolute targets must be at the core of any EC-wide

<sup>58</sup> Interviews in Brussels, 15–16 May 2006.

<sup>59</sup> *ENDS Daily* (29 June 2001), 'EU Emission Trading Scheme Proposal Delayed', Issue 1020; Reuters/Planetark (2 July 2001), 'EU Delays Discussion of Climate Emissions Plan'.

<sup>60</sup> *Ibid.* *ENDS Daily* (29 June 2001).

<sup>61</sup> *Ibid.*

<sup>62</sup> For example, under the direct approach, if Denmark emits more by producing electricity which is exported to Norway, the emissions of the exported electricity are not taken into account. See Vis (2006a).

<sup>63</sup> European Chemical Industry Council [website], <<http://www.cefic.be/Templates/shwStory.asp?NID=537&HID=538>>.

emissions trading scheme. But with appropriate safeguards built in, there can also be a limited role for relative targets'.<sup>64</sup>

Encouraged by the outcome of the Bonn UNFCCC meeting in July 2001, the Commission stepped up its efforts to ensure that the ET proposal would be adopted by the end of the year. To counter the criticism concerning inadequate consultation, two 'stakeholder consultation meetings' were, as noted, held in September. The first one targeted industry and ENGOs and was held on 4 September.<sup>65</sup> It was chaired by Jos Delbeke and attended by 15 Commission officials, representing DG ENV (four), DG ECFIN (one), DG Enterprise (four), DG TREN (four), DG Market (one), and DG Trade (one). From the stakeholder side, there were 52 representatives, mostly from the industrial side (close to 50). These included the European Roundtable of Industrialists, European Chambers of Commerce, UNICE, various Euro-federations like EURELECTRIC and EUROPIA, as well as national members of UNICE, like the Confederations of British and German industries. From the ENGO side, the WWF, Climate Action Network Europe and FIELD were represented by the same persons as in ECCP WG 1. Attendance by industry was much broader than in the ECCP WG1 meetings. This meeting also points up the dramatic difference in resources and numbers between industry and ENGOs. A further difference was that member-state representatives did not attend. The Commission described the meeting as being much tougher than the consultation meeting with member-state representatives held some days later.

A central item was the mandatory nature of the system, including the relationship between existing voluntary 'long-term' agreements and emissions trading. If such agreements did what was necessary, why should other approaches be needed? This issue reflected the position of German industry, which strongly opposed a mandatory EU ETS. This position was reiterated by German governmental representatives at the 10 September consultation meeting with the member-states. Others maintained that emissions trading offered a far more transparent and equitable distribution of efforts within and between sectors than voluntary agreements.<sup>66</sup> With regard to allocation, it was stressed that transparency was crucial. Member-states were to decide upon exact allocations, on the basis of criteria established at EU level.<sup>67</sup> The Chairman concluded that there was an overwhelming majority in favour of going ahead with emissions trading sooner rather than later. In contrast to ECCP WG 1 where UK representatives participated, there was also a decisive majority in favour of a 'direct' emissions approach for electricity producers, which was considered simpler. A key 'take-away message' was the wish 'to see greater distinction between the period

<sup>64</sup> European Commission (2 May 2001), ECCP Working Group 1, Final report (Brussels), 4.

<sup>65</sup> European Commission (17 September 2001), Chairman's Summary Record of Stakeholder Consultation Meeting (with industry and environmental NGOs) 4 September 2001 (Brussels).

<sup>66</sup> *Ibid.*, 2.

<sup>67</sup> *Ibid.*, 3, 4.

prior to 2008 compared to the period post-2008', meaning that the scheme should be more flexible in the period prior to the Kyoto commitments.<sup>68</sup>

A revised draft ET directive proposal was ready by mid-September. At least four changes in the policy direction of flexibility emphasized and preferred by industry were evident here. First, opt-out clauses had been added, enabling member-states to temporarily exclude installations from the system before 2008. Second, governments could issue extra allowances to companies likely to exceed their original allowance allocation in 'unforeseen circumstances' and due to 'market conditions'. Both these steps would be subject to Commission approval, however, and would also need to be in line with EU rules on state aid. Third, free-of-charge allocation was put forward as the standard approach in the pilot phase, ruling out the option of auctioning in this phase. Fourth, the proposed penalty for exceeding the allowed emission quantity was reduced considerably, from €200 to €50 per tonne additional CO<sub>2</sub> until 2008, and €100 thereafter – or double the average market price of allowances, if this was higher.<sup>69</sup>

Comparing these changes with the positions of the member-states at the consultation meeting six days later, we find little to suggest that the changes were required by a majority of the member-states – with the possible exception of free allocation, which was preferred by a majority of the member-states as well. Similarly, several observers concluded that many of these changes were a direct result of business pressure.<sup>70</sup> For instance Enterprise Commissioner Liikanen had come under heavy pressure from German industry, which claimed that the ETS would disrupt existing voluntary agreements in Germany.<sup>71</sup>

As CoP-7 in Marrakech was to start in late October, pressure was now building up on the Commission to reach agreement on the ET proposal prior to CoP-7. The World Wildlife Fund appealed to Romano Prodi to break the 'logjam' and not let 'petty disagreements among European Commissioners' lead to 'the EU shooting itself in the foot'.<sup>72</sup> Such a political accident was avoided when the formal EU ET directive proposal was in fact put forward on 23 October 2001 – six days before CoP-7.<sup>73</sup> Compared with the mid-September draft proposal, there was a reversion

<sup>68</sup> *Ibid.*, 7.

<sup>69</sup> European Commission (14 September 2001), Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC, (draft) version for interservice re-consultation (Brussels).

<sup>70</sup> *ENDS Daily* (2 October 2001), 'Wallstrom Sweetens Emission Trading Pill', Issue 1072; Reuters/Planetark (2 October 2001), 'EU Eases CO<sub>2</sub> Trading Rules After Industry Pressure'.

<sup>71</sup> *ENDS Daily* (23 October 2001), 'EU Makes Its Move to Ratify Kyoto Protocol', Issue 1087.

<sup>72</sup> WWF (22 October 2001), 'EU: Don't Shoot Yourself in the Foot over Climate Change', press release.

<sup>73</sup> European Commission (23 October 2001), COM(2001)581, Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC (Brussels).

to some of the concessions to industry. Both the opt-out clause and the opening for issuing additional allowances due to 'market conditions' had been deleted. Worried about loopholes and competition concerns within the internal market, key figures like Competition Commissioner Monti and Internal Market Commissioner Bolkestein backed Environment Commissioner Wallström in the fight with Enterprise Commissioner Liikanen. A deal had been made at the Commissioner level and 'Wallström had cut through', surprising both industry and even the BEST group itself.<sup>74</sup>

The exclusion of the chemical sector, was, however, upheld.<sup>75</sup> The Commission's official reasons were, first, that the sector's direct emissions of CO<sub>2</sub> were 'not so significant'.<sup>76</sup> Second, the number of installations was high, in the order of 34,000 plants, which would increase the administrative complexity of the scheme. The first of these arguments is not very persuasive. Emissions from the chemicals sector were higher than for pulp and paper and about the same as from the mineral industry – both of which were included in the proposal.<sup>77</sup>

A third reason for excluding this sector was political: the European chemical industry represented by CEFIC is powerful. According to the European Commission, the chemicals industry is the third largest manufacturing industry in the EU, employing 1.9 million people and with a leading international position – all of which make it important to the EU economy.<sup>78</sup> As noted in Chapter 4, the chemical industry has not been very supportive of emissions trading and has been a strong advocate of relative targets, arguing that it is particularly vulnerable to international competition.<sup>79</sup> It is illustrative that the chemical industry walked out of the German working group on emissions trading in late 2001. The Chemical Industry Associations (VCI) is one of the strongest and most powerful industry associations in Germany. Excluding the chemical industry would serve to silence the VCI and thereby weaken internal opposition to emissions trading within Germany.

<sup>74</sup> *ENDS Daily* (23 October 2001), 'EU Makes Its Move to Ratify Kyoto Protocol', Issue 1087; interviews in Brussels, 15–16 May 2006.

<sup>75</sup> Although CO<sub>2</sub> emissions from on-site power and heat generation would be included if they exceed 20 MW.

<sup>76</sup> European Commission (23 October 2001), COM(2001)581, Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC (Brussels), 10.

<sup>77</sup> Notice that 1990 emissions figures are used in the directive proposal, where it is argued that emissions from the chemicals sector represent 1 per cent of the EU's total emissions (26 million tonnes). In the 2000 Green Paper, however, 1997 figures are used, showing that paper and pulp represents 1 per cent, chemicals 2.5 and minerals 2.7 per cent of CO<sub>2</sub> emissions from the EU 15.

<sup>78</sup> European Commission (February 2006), *Environment fact sheet: REACH – a new chemicals policy for the EU*, <[http://ec.europa.eu/environment/chemicals/reach/fact\\_sheet.pdf](http://ec.europa.eu/environment/chemicals/reach/fact_sheet.pdf)> accessed 15 June 2007.

<sup>79</sup> European Chemical Industry Council [website], <<http://www.cefic.be/Templates/shwStory.asp?NID=537&HID=538>>

The chemical industry was also singled out for another major policy initiative at this time. In February 2001, the plan for a new chemicals policy was introduced to the chemical industry by the White Paper on EU Chemicals Policy Review (the REACH process).<sup>80</sup> To make this major policy initiative function, requiring producers and importers of chemicals to register them, the DGs for the environment and enterprise would need a certain degree of cooperation from CEFIC. It is reasonable to assume that excluding the chemical industry from the EU ETS would make them more cooperative in the development of REACH.

The Commission managed to maintain its main design ideas throughout the drafting process. This shows that DG Environment can withstand industry pressure aimed at weakening environmental policy instruments when it can make alliances with other powerful parts of the Commission. On the other hand, it also points up the limitations of the Commission when it comes to withstanding pressure from industry. This is particularly visible in the continued exclusion of the chemicals sector. Although verification is difficult, there is much to suggest that the exclusion of the chemicals sector was also tactically motivated, related to weakening German opposition to emissions trading and strengthening cooperation with the chemical industry in the upcoming REACH process.

#### *The Parliament's First Reading and the Common Position*

In Chapter 3, we saw that the European Parliament suggested some 80 amendments to the ET directive proposal at its first reading. To what extent – and why – was the Parliament able to affect the common position to be adopted by the member-states in the Council in December 2002? Changes introduced to the common position, such as an opening for more auctioning, are difficult to understand on the basis of the intergovernmental perspective discussed earlier. According to the co-decision procedure applied in this case, the Parliament has the right to propose amendments to the Commission proposal.<sup>81</sup> The Parliament can veto the adoption of the whole proposal if it thinks that its amendments have not been taken sufficiently into account in the final text. This gives the Parliament significant formal power in the decision-making process. Amendments are proposed through 'readings'. The proposal can be adopted at the first reading if the Council accepts the Parliament's amendments. If not, the Council adopts a 'common position', as in the case of the EU ETS. The proposal then goes to a second reading, which will be assessed in the next section.

In the first part, we assess the amendments proposed and the degree of unity behind them. In the second part, we analyse the Parliament's actual impact on the common position and discuss the reasons for its influence, particularly in light of the role of the European Commission.

*First reading* In the autumn of 2001, the proposed ET directive was immediately criticized by the Green Party in the European Parliament. Green Party MEP Alexander

<sup>80</sup> The REACH (Registration, Evaluation, Authorisation and Restriction of Chemicals) Regulation was formally adopted on 18 December 2006, to enter into force on 1 June 2007.

<sup>81</sup> This description of the co-decision procedure is based on Lefevere (2005, 100).



de Roo particularly disagreed with handing out allowances free of charge, stating that 'the US experience in sulphur emissions trading has proven that, if you start with a bad model, it is politically impossible to switch back later on'.<sup>82</sup>

Warming up to the first reading process in the European Parliament, ET rapporteur Jorge Moreira da Silva, EPP-ED<sup>83</sup> Portugal outlined his provisional ET position at a Brussels sustainable energy conference in mid-February 2002. Da Silva told the conference that he would urge the Parliament to push for a more centralized trading scheme than that proposed by the Commission. He stated that there was 'too much subsidiarity' in the proposal and that he would not 'follow the line of giving freedom to member-states to set a cap'. Instead, the EU should set an overall cap on emissions from the sectors concerned, and either distribute these to companies directly or share the cap between the 15 member-states for governments to distribute. As to allocation of allowances, da Silva indicated a preference for a mixture of free allocation (grandfathering) and for payment (auctioning). Otherwise, he praised the proposal as '90% very good' and indicated that he would not propose extending its coverage either to include more gases or industry sectors.<sup>84</sup> With this statement, more centralized Community level control over national allocation of allowances and more auctioning in the allocation of allowances were to become the two major issues for the European Parliament. In fact, however, the EP came to develop amendment proposals on most aspects of the proposed ET directive.

The first reading process in the European Parliament got underway in late March 2002 with a discussion on the ET proposal in the EP Legal Affairs Committee. The interests of the UK, Germany and Finland could immediately be seen in the opposition of British, German and Finnish MEPs to a mandatory pilot phase 2005–07.<sup>85</sup> The Parliament's Environment Committee debated a preliminary report put forward by rapporteur da Silva in mid-April 2002. By then, da Silva had abandoned the idea of setting allowance caps at EU rather than national level. However, he proposed introducing a limit on the distribution of allowances in order to prevent 'over-allocation' distorting the market. With regard to method of allocation, in the pilot phase of the EU ETS, 70 per cent of the allowances should be handed out free of charge, while 30 per cent should be auctioned. In the second phase (2008–12), all allowances should be auctioned.

At this stage, it was clear that the '90% good' view was withering, as da Silva also proposed significant changes in coverage: the scheme's scope should be broadened to include other gases and sectors 'at the earliest possible stage'.<sup>86</sup> Most Committee

<sup>82</sup> *International Environment Reporter* (24 October 2001), 'EU Commission Advances Legislation Including Emissions Trading Scheme', 24:22, 907.

<sup>83</sup> EPP-ED is the Group of the European People's Party (Christian Democrats) and European Democrats. From 1999 to June 2004, it was the largest group in the European Parliament, with 232 of the total of 625 seats.

<sup>84</sup> *ENDS Daily* (21 February 2002), 'MEP Outlines Plans for EU Carbon Trading', Issue 1163.

<sup>85</sup> *ENDS Daily* (27 March, 2002), 'MEPs Debate EU Climate Gas Trading Plan', Issue 1187.

<sup>86</sup> Moreover, it was suggested to ban CDM credits derived from sinks, nuclear or large-scale fossil sources.

members speaking in the debate called for coverage of more gases and more sectors, and especially the chemicals sector. German, British and Finnish MEPs again questioned the need for a mandatory system in the pilot phase.<sup>87</sup>

The Environment Committee then adopted its main positions at its meeting on 10 September, in what was described as 'a marathon voting session involving hundreds of amendments'.<sup>88</sup> In fact, nearly 500 amendments were tabled in the Committee.<sup>89</sup> The Committee backed the Commission's proposal for a mandatory system from the outset. This means that British, German and Finnish MEPs did not get their way with a voluntary scheme in the pilot phase. As a concession, however, the Committee opened up for member-states to temporarily exempt individual installations (opt-out) if they put in equivalent efforts to limit emissions, subject to Commission approval (Amendment 50). As in the negotiations among the member-states, the question of mandatory participation was reported as 'the thorniest issue in the Committee'.<sup>90</sup> This exemption clearly responded to the interests of the UK in particular, but also Germany and Finland. Even though the MEPs from these countries belonged to different party groups in the EP, they stood together behind the proposal to give countries the opt-out possibility in the pilot phase. This proposed amendment was to end up as an actual amendment in the common position.

Furthermore, it was suggested that there be a cap on the total quantity of allowances to be allocated to each member-states, representing roughly half of the emissions forecast in the relevant period in each member-state (Amendment 24). As to coverage, the Committee sought a significant broadening of the scope of the scheme, in terms of sectors and gases. The two new 'activities'/sectors of chemicals and aluminium were suggested for inclusion, as well as all six Kyoto gases, provided that data quality and 'acceptable measurement, monitoring and calculation methods' were developed by the Commission (Amendments 17, 54 and 61). Moreover, the inclusion (voluntary opt-in) in some member-states of additional sectors and activities that would not distort competition should also be allowed from 2005 on (Amendment 16). Also this ended up as a change in the common position.

With regard to method of allocation, the rapporteur's plea for more auctioning did not win the support of the Committee, and the Commission's proposal was left unaltered on this point (distribution free of charge). This indicates successful

<sup>87</sup> *ENDS Daily* (23 April 2002), 'EU Climate Trading Scheme in the Spotlight', Issue 1202; *International Environment Reporter* (8 May 2002), 'Euro Parliament's Environment Committee Calls for Changes to GHG Trading Proposal', 25:10, 471–2.

<sup>88</sup> European Parliament (13 September 2002), Report on the Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC, COM(2001)581 (Committee on the Environment, Public Health and Consumer Policy, Final, A5-0303/2002); *ENDS Daily* (11 September 2002), 'MEPs Back Mandatory Climate Emission Trading', Issue 1284; *International Environment Reporter* (25 September 2002), 'EU Parliamentary Committee Approves Industry Exemptions for Kyoto Trading', 25:20, 897–8.

<sup>89</sup> *Europe Environment* (20 September 2002), 'Climate Change: MEPs Vote on Emissions Trading Plan', 618, 1.

<sup>90</sup> *Ibid.*

lobbying by industry which generally opposed allocation for payment. As to links to the Kyoto flexible mechanisms (JI and CDM), the Committee did not agree that credits from such projects would 'fall within the scope of the directive' in the pilot phase. Such credits could be used in the period 2008–12, on the condition that the projects did not 'include carbon sinks or sources of energy which use nuclear power' (Amendment 53). All in all, 74 amendments were adopted, and the draft legislative resolution was adopted by 39 votes to 7, with 6 abstentions.<sup>91</sup> Rapporteur da Silva was quoted as being 'delighted with the outcome of the vote'.<sup>92</sup>

In the run-up to the Parliament's plenary first reading, environmental NGOs sought to influence particularly the part about allocation, and four ENGOs lent their support to the EP rapporteur's plea for significant room for auctioning of allowances in order to 'provide an incentive for early action to improve energy efficiency'.<sup>93</sup> The first reading then took place on 10 October.<sup>94</sup> All the Environment Committee amendments listed above were approved by the plenary, including the backing of a mandatory scheme from the start, a broad scope including all six Kyoto Protocol gases and emissions from chemicals and aluminium plants, and a cap on the total quantity of allowances to be allocated to each member-state.

A few additional amendments were adopted as well, bringing the total number up to around 80. The major addition was a proposal for allowance auctioning, in line with the wishes of both the rapporteur and several ENGOs (although da Silva's initial proposal called for twice as much auctioning). For both the pilot period 2005–07 and the Kyoto commitment period 2008–12, member-states were to ('shall') allocate 15 per cent of the allowances 'against payment' (Amendment 102, Article 10). This proposal was clearly contentious, and was passed by a majority of only three votes.<sup>95</sup> Otherwise, the Parliament adopted the rapporteur's ET draft report with a large majority: 381 to 66 votes, with 38 abstentions.<sup>96</sup>

<sup>91</sup> European Parliament (13 September 2002), Report on the Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community and Amending Council Directive 96/61/EC, COM(2001)581 (Committee on the Environment, Public Health and Consumer Policy, Final, A5-0303/2002).

<sup>92</sup> *Europe Environment* (20 September 2002), 'Climate Change: MEPs Vote on Emissions Trading Plan', 618, 1.

<sup>93</sup> These four ENGOs were Birdlife International, Climate Action Network Europe, Friends of the Earth Europe and WWF. *ENDS Daily* (7 October 2002), 'NGOs Keep Up Pressure on Emissions Trading', Issue 1302; *EurActiv* (10 October 2002), 'EU Emissions Trading Scheme on Parliament's Agenda'.

<sup>94</sup> European Parliament (10 October 2002), Greenhouse Gas Emission Allowance Trading – European Parliament Legislative Resolution on the Proposal for a European Parliament and Council Directive Establishing a Scheme for Greenhouse Gas Emissions Allowance Trading within the Community and Amending Council Directive 96/61/EC, COM(2001)581, P5\_TA-PROV(2002)0461.

<sup>95</sup> *ENDS Daily* (10 October 2002), 'MEPs Back Early Mandatory Climate Trading', Issue 1305.

<sup>96</sup> *Euractiv* (11 October 2002), 'Parliament Ups Ambitions for Greenhouse Gas Emissions Scheme'.

The outcome of the Parliament's first reading shows that it pressed for a higher degree of harmonization at EU level, functioning mainly as a watchdog for the environmental integrity of the proposal. The main notable exception to this picture is the opening up for a temporary opt-out of individual installations. The Commission's ET proposal and the changes suggested in the Parliament's first reading are summed up in Table 5.2.

Most of these suggested changes were backed by large majorities in the European Parliament. With regard to method of allocation, however, the call for

**Table 5.2 Key changes suggested in the Parliament's first reading**

	Type of system	Coverage/scope	Method of allocation	Compliance and enforcement
<b>Commission proposal October 2001</b>	Mandatory system but decentralized setting of emission caps	Start with CO <sub>2</sub> only and four targeted 'activities' <sup>a</sup> Opt-in of additional sectors and activities from 2008 on	Free of charge allocation in pilot phase; next phase to be decided in 2006 review	Penalty: either €50 (pilot phase)/€100 (Kyoto phase) or twice the average market price 'whichever is higher'
<b>Changes suggested in Parliament first reading</b>	Cap on total quantity of allowances to be allocated to each MS	All six Kyoto gases Chemicals and aluminium sectors also included Temporary exemption/opt-out of individual installations Opt-in of additional sectors and activities already from 2005	Mandatory auctioning of 15% of allowances in both pilot and Kyoto phases	No changes suggested

<sup>a</sup>These were (a) energy (combustion, refineries and coke ovens); (b) ferrous metals; (c) mineral industry (cement, glass, ceramic) and (d) other activities (pulp and paper).

a significant element of auctioning was controversial, and was passed by only a very slight majority. According to Brussels insiders, ET rapporteur da Silva did a very good job, exerting skilful leadership in facilitating a high degree of unity in the EP.<sup>97</sup> This included the creation of a small group of dedicated 'trading MEPs' comprising 10 to 12 key people – in a way, the EP counterpart to the BEST group

<sup>97</sup> Interviews in Brussels, 26 May 2004.

in the Commission. Several aspects of da Silva's background were favourable for his ability to forge compromises between differing factions and groups in the Parliament. He was elected from one of EU's Southern countries (which helped to mute the idea that emissions trading was a 'Northern conspiracy') and represented the central conservative/liberal group in the Parliament. On the other hand, he did not succeed in keeping the EP's focus directed to a few key issues. As the process developed, the '90% good' strategy faltered as the EP came to propose amendments to most key aspects of the proposed ET directive.

Lobbying from industry and NGOs affected the proposed amendments and the level of agreement. On the issue of the system's mandatory nature, industries from particularly Germany and the UK (in tandem with governmental representatives from these countries) emerged as a significant force pushing for the opt-out clause for installations. On the issue of allocation, the strong call for auctioning voiced by important environmental NGOs went hand in hand with the Parliament's first reading stance on this issue. Both these proposed amendments were among the most controversial ones that were adopted.

*The common position* After the Parliament's first reading, the Commission responded quite quickly. At a Brussels conference on 15 October, Environment Commissioner Wallström delivered a 'passionate defence' of the Commission's initial design, arguing strongly for unconditional participation by all countries' installations and no auctioning of allowances in the pilot phase. She warned that such auctioning could jeopardize already equivocal support from industry, stating that 'any amount of auctioning, however small, will make it even harder for businesses to accept emissions trading'.<sup>98</sup> This was followed by the Commission's official and main response to the Parliament's first reading, published on 27 November 2002.<sup>99</sup> It was here clarified that the Commission fully accepted the general comments of the EP, such as that the EU's climate change strategy should be built on a balance between emissions trading and other types of Community, domestic and international action.<sup>100</sup> Among the elements that the Commission accepted only in part or in principle were minor adjustments regarding the issues of transparency, reporting and review.

But many amendments were *not* accepted at all by the Commission – in fact, a total of 55 amendments. Among the amendments and suggestions not deemed acceptable were all the main proposed amendments (see Table 5.2):

<sup>98</sup> *ENDS Daily* (16 October 2002), 'Commission Holds Firm on EU Climate Gas Trading', Issue 1309.

<sup>99</sup> European Commission (27 November 2002), COM(2002)680 final, Amended Proposal for a Directive of the European Parliament and of the Council Establishing a Scheme for Greenhouse Gas Emissions Trading within the Community and Amending Council Directive 96/61/EC (Brussels).

<sup>100</sup> Among other amendments that were accepted: 'naming and shaming' of non-compliers should be used sparingly, and the reference to a penalty level 'twice the average market price etc' could be deleted; the review of the scheme should include additional elements such as the relationship between the EU ETS and international emissions trading and possible needs to adapt the scheme in light of EU enlargement.

- cap on total quantity of allowances to be allocated to each member-state;
- temporary exemption/opt-out of individual installations until 2007;
- inclusion of other gases than CO<sub>2</sub> and inclusion of the aluminium and chemicals sectors;
- mandatory auctioning of 15 per cent in both the pilot and Kyoto commitment period.<sup>101</sup>

The time had now come for the Council of Environmental Ministers to discuss and adopt a common position on the ET proposal. As described earlier, the Danish presidency played an important and constructive facilitating role in preparing a position that would be acceptable to all member-states. In this process, important support came from DG Environment and the BEST group, which helped in writing the final compromise proposal (Watanabe 2005, 20).<sup>102</sup> Furthermore, the Commission was generally very active behind the scenes in the Council negotiations, explaining the various elements of trading system design to the member-states.<sup>103</sup> The positions of some members were not fixed; moreover, the fact that the BEST group had worked on emissions trading much longer than most member-states gave the Commission an important role to play also in the decision-making process.

The main outcome of the negotiations was that the Council chose to uphold the body of the Commission's design that had been put forward a year earlier.<sup>104</sup> The Council wanted:

- a mandatory but still decentralized system, with a right for the Commission to approve National Allocation Plans, but no cap on total quantity of allowances;
- a system initially covering only CO<sub>2</sub> and with sectoral coverage in line with the Commission proposal, organized into four main 'activities' as in the Commission proposal, excluding aluminium and chemicals (see Annex I of the common position);
- allowances allocated free of charge in the pilot phase 2005–07.

Hence, it is understandable that Environment Commissioner Wallström was 'extremely pleased' that the architecture and main design of the European

<sup>101</sup> As to other non-acceptable elements, these included references to allowances being allocated in accordance with 'best available techniques' and CHP generation specifically; references to emissions trading 'not replacing existing charges on energy and CO<sub>2</sub> emissions'; explicitly mentioning that linking trading schemes with other Kyoto parties would encourage the US to come back on board; and obligatory rewarding early action between 1990 and 2004.

<sup>102</sup> Interviews in Brussels, January 12–13 and May 15–16 2006.

<sup>103</sup> Interviews in Brussels, January 12–13 and May 15–16 2006.

<sup>104</sup> The common position was formally adopted in March 2003. Council (18 March 2003), 15792/1/02, Common Position Adopted by the Council on 18 March with a View to the Adoption of Directive of the European Parliament and of the Council Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and Amending Council Directive 96/61/EC (Brussels: Council of the European Union).

Commission's proposal had remained in place. But also WWF and industrial lobbyists were reported to be satisfied with the outcome.<sup>105</sup>

Still, in comparison with the Commission proposal, changes allowing for 'trading pools', 'opt-in', 'opt-out of installations and sectors/activities', auctioning and lower penalties were introduced in the common position. Of these, more auctioning can be attributed to the EP and the member-states favouring auctioning. The possibility for member-states to allocate up to 10 percent of allowances from 2008 by methods other than free of charge may be seen as a very watered-down version of the Parliament's proposal in its first reading (15 per cent auctioning from 2005 on). This inclusion was in line with the position of ENGOs and some member-states, but against the positions of the Commission, industry and a majority of the member-states. However, the compromise allowed those member-states who preferred auctioning to auction up to 10 per cent of allowances, without forcing opponents to engage in any auctioning at all. The 'opt-out' was supported by the Parliament's first reading – but only for individual installations, not whole sectors. This was a concession to the UK, as well as Germany and Finland, in return for a mandatory system. In sum, we may say that the first reading in the EP led only to some minor changes in the Commission's proposal that fully or partly can be traced back to EP proposals.

The Parliament wanted far more radical changes than what was reflected in the common position – with regard to a cap on total quantity of allowances allocated to each member-state, the scope of the system in terms of gases and sectors included, and the method of allocation. Why this gap between the Parliament's wishes and the results? First, the formal and informal inputs from the Commission was important. In its formal response to the Parliament, the Commission firmly rejected a cap on total allocations, broader scope of the system, and a significant role for auctioning in the allocation of allowances. In combination with work behind the scenes, the Commission seems to have made a significant impact on the process in the Council. As can be recalled from Chapter 2, in order to get the amendments rejected by the Commission adopted in the Council, unanimous support is needed if there is to be a first-reading agreement or in second reading. Second, the large number of amendments proposed by the EP probably weakened its impact. If the Parliament had supported da Silva's initial '90% good' assessment and focused on a few core issues, the impact might have been greater. The level of agreement behind the various proposals does not seem to be a potent explanatory factor. The wish for more auctioning had the smallest majority backing among the various proposals in the EP, but this proposal actually did affect the common position somewhat.

### *Second Reading and the ET Directive*

In the second reading, the Parliament may propose new amendments to the Council's common position. If the Council and Parliament cannot agree on these amendments, a conciliation committee seeks agreement between the Council and Parliament. If

<sup>105</sup> *ENDS Daily* (9 December 2002), 'Ministers Agree EU Climate Gas Trading Scheme', Issue 1346.

agreement on the final text cannot be reached, the Parliament may vote to veto the adoption of the proposal.

The immediate response from the Parliament's ET rapporteur did not bode well for the final spurt in this process. In a speech to a Brussels climate change conference on 10 December 2002, da Silva indicated that the Parliament was not likely to accept the common position among the member-states and that he expected the second reading to be 'quite difficult'. He also expressed worries over the tight timetable.<sup>106</sup> These positions were further clarified early in January 2003.<sup>107</sup> At this stage, four issues were singled out as contentious, since the Parliament still wanted:

- a temporary opt-out only for installations, not sectors;
- the inclusion of other sectors (especially aluminium and chemicals) and other gases already from 2005;
- the auctioning of 15 per cent of the allowances already from 2005;
- linking the Kyoto mechanisms only from 2008, not from 2005.

In fact, da Silva was quoted as expecting the issue to go to a conciliation committee.<sup>108</sup> A conciliation process would have delayed the decision-making process and made the 2005 start less certain (Lefevre 2005, 101).

The next main ETS movement within the EU institutional machinery was a new formal response from the Commission, in the form of a Communication to the European Parliament, published on 25 March 2003.<sup>109</sup> The Commission underlined that the common position *did* incorporate many of the Parliament's first reading amendments: all the 18 amendments from the Parliament's first reading accepted totally or partly by the Commission had been incorporated in the common position. It also argued that other amendments not accepted by the Commission had been included in the common position, such as the temporary exclusion of certain installations, the inclusion of additional sectors and gases, and revision in the method of allocation.

As to the relationship to the Kyoto Protocol's flexible mechanisms, it was pointed out that the Commission had made a statement for the minutes of the Council meeting about 'its intention to propose, by the first half of 2003, a Directive for linking the Kyoto mechanisms with the Community greenhouse emission trading scheme'.<sup>110</sup>

<sup>106</sup> *Euractiv* (13 December 2002), 'Parliament Set for Fight against Council Agreement on Emissions Trading'.

<sup>107</sup> *International Environment Reporter* (15 January 2003), 'Climate Change: Final Legislative Approval of EU's Plan for Emissions Trading Expected Around 2004', 26:2, 80–81.

<sup>108</sup> *Ibid.*

<sup>109</sup> European Commission (25 March 2003), SEC(2003)364 final, Communication from the Commission to the European Parliament, pursuant to the second subparagraph of Article 251(2) of the EC Treaty, concerning the Common Position of the Council on the adoption of a Directive of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (Brussels).

<sup>110</sup> *Ibid.*, 11.



This decoupling of issues helped to lessen the complexity in the negotiations. It also helped to reduce opposition to the proposed ET directive from the Parliament, as it was clear that the Parliament wanted more restrictions on linking than did industry and a majority of member-states. The Communication ended by supporting the common position, while emphasizing that 'prompt finalization' of the emissions trading directive was necessary in order to keep the timetable and ensure European leadership in the fight against climate change.<sup>111</sup>

The subsequent main step in the EU institutional procedure was the second reading in the European Parliament. The Environment Committee debated the ETS in meetings on 29 April and 11 June. At the first meeting, 14 amendments were put on the table. These included a re-tabling of first reading proposals calling for opt-outs only for installations (not sectors), and broader coverage in terms of gases and sectors. The call for a cap on the amount of allowances available for distribution was repeated. On the issue of auctioning, the call was still for this to be included already from 2005 on, but from 15 per cent down to 5 per cent.<sup>112</sup>

It is clear that this second reading process took place in an atmosphere of increasing political urgency. The EU did not have much time to get the system in place so as to be able to show 'demonstrable progress by 2005'. As we shall see in the next section, the EU ETS had by then become an important tool for saving the Kyoto Protocol in a situation where the USA was out and there was uncertainty about Russian ratification. On 22 May, the Parliament's ET rapporteur da Silva stated: 'If we postpone a decision it will create enormous problems for national authorities and companies'.<sup>113</sup> In such an atmosphere, the willingness to compromise increases. The Parliament is normally lobbied and encouraged by environmental groups to adopt amendments that are more ambitious than those on the negotiating table. At this stage in the ETS process, according to Lefevere (2005, 101), the Parliament was lobbied by 'a broad range of stakeholders, including industry, environmental NGOs, the European Commission and most member-states, to avoid proposing too many amendments and accept the Common Position' (emphasis added).

In contrast to the 74 amendments adopted in the first reading, on 11 June 2003 the Parliament's Environment Committee agreed to re-table 25 of the amendments put forward in the first reading process – by 47 votes against 3, with two abstentions.<sup>114</sup> Among these 25 amendments were the inclusion of all six greenhouse gases and the inclusion of the chemicals and aluminium industries. Furthermore, recognizing the time constraints involved, the Committee singled out four truly key issues for this final phase (see Table 5.3).

<sup>111</sup> Ibid., 12.

<sup>112</sup> *ENDS Daily* (30 April 2003), 'Call for Tougher EU Emission Trading Maintained', Issue 1434.

<sup>113</sup> Reuters/Planetark (22 May 2003), 'EU Assembly to Push for Greenhouse Gas Trading Deal'.

<sup>114</sup> European Parliament (12 June 2003), Recommendation for Second Reading on the Council Common Position for Adopting a European Parliament and Council Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and Amending Council Directive 96/61/EC (15792/2002-C5-0135/2003-2001/0245 (COD), A-5-0207/2003).

**Table 5.3 Key changes suggested in the Parliament's second reading**

	Type of system	Coverage/scope	Method of allocation	Compliance and enforcement
<b>Commission proposal October 2001</b>	Mandatory system but decentralized setting of emission caps	Start with CO <sub>2</sub> only and four targeted 'activities'  Opt-in of additional sectors and activities from 2008 on	Free of charge allocation in pilot phase; next phase to be decided in 2006 review	Penalty: either €50 (pilot phase)/ €100 (Kyoto phase) or twice the average market price – 'whichever is higher'
<b>Changes suggested in Parliament second reading</b>	National ceiling/ 'cap' for emission allowances to prevent over-allocations based on a linear curve consistent with the member-state's Kyoto commitments;	Temporary and limited opt-outs for installations should be possible under three strict conditions <sup>a</sup>  The directive should be revised in 2006 to include other sectors, especially the transport sector	Method of allocating allowances should be harmonized, with allocation free of charge and 5% auctioning from 2008	No changes suggested

<sup>a</sup> Installations should be subject to (a) equal emissions reductions as a result of other national policies; (b) equal monitoring, reporting and verification; and (c) equal penalties. No opt-outs for whole sectors as proposed by the Council.

In addition to these four issues, credits from the flexible mechanisms under the Kyoto Protocol could be linked to the EU ETS, but the MEPs wanted a guarantee that priority would be given to domestic action.<sup>115</sup> Two of these issues were reported to be 'verging on the non-negotiable': the national ceiling and the opt-out issues.<sup>116</sup> The plenary discussion and vote in the Parliament were scheduled for early July. However, as noted earlier, negotiations between the EP and the Council were initiated rapidly after the vote in the Environment Committee, and had a deadline of 20 June. They primarily involved the Parliament's ET rapporteur, the Presidency and

<sup>115</sup> *ENDS Daily* (11 June 2003), 'MEPs Push for a Quick Deal on EU Climate Trading', Issue 1460; *Euractiv* (12 June 2003), 'Greenhouse Gas Trading: MEPs Hope to Avoid Conciliation'; *Europe Environment* (13 June 2003), 'Climate Policy: MEPs Stand Firm Over Trading of Greenhouse Gas Emission Rights', 636, 22–3.

<sup>116</sup> *Europe Environment*, *ibid.*, 23.

the Commission, with the Rapporteur determined not to become 'embroiled in the arcana of the Council. <and> a monster with 15, or even 25 heads'.<sup>117</sup>

Following compromise proposals tabled on 23 June by EU member-state representatives, the negotiations met with success on 25 June.<sup>118</sup> This final character of the process has been characterized as unique, including the fact that 'unlike virtually all other major pieces of environmental legislation recently adopted by the European Community under the co-decision procedure, the ET directive did not go into conciliation' (Lefevere 2005, 101).

On the key and 'almost non-negotiable' issue of a national ceiling for allowances, the Parliament did not win through. Instead, the compromise outcome was that the total quantity of allowances should 'not be more than what is likely to be needed for a strict application of the relevant criteria'. Prior to 2008, the total amount of allowances should be 'consistent with a path towards achieving or over-achieving' Kyoto targets. With regard to the other really key issue of opt-outs, the Parliament was more successful. Here, the outcome was an opening up for temporary opt-outs only for installations, but not for whole sectors – just as emphasized by the Parliament's Environment Committee.

As to the revision of the directive, the Commission was to produce a report on the possible further broadening and development of the ETS, for submission to the Parliament and the Council by 30 June 2006. On the method of allocating allowances, the Parliament did not win through fully. The outcome was not that a specific percentage of allowances would be auctioned after 2008. Instead, a more indirect approach was chosen, whereby at least 95 per cent of the allowances were to be allocated free of charge before 2008, and at least 90 per cent after 2008. Article 30(2)(c) also anticipated further harmonization of the method of allocation, including auctioning for the period after 2012.

As to other issues, we should note that on the question of credits from the project mechanisms of the Kyoto Protocol, the Parliament did not get its requested 'guarantee' that priority should be given to domestic action. However, it was stated that the use of the mechanisms should be 'supplemental to domestic action' and such action should 'constitute a significant element of the effort made'. The setting of a cap on linking would become one major issue in the negotiations on the Linking Directive (see next section). The Parliament was moderately successful with regard to the inclusion of other sectors and gases. A general broadening remained optional and dependent upon the outcome of the subsequent review, but the chemicals, aluminium and transport sectors were at least explicitly mentioned as particularly relevant candidates for possible broadening.

We can now sum up the main steps and outcomes in the process. Table 5.4 shows how the Parliament's proposals became watered down over time:

<sup>117</sup> Ibid., 22–23.

<sup>118</sup> Council (23 June 2003), Revised Council Proposal for Second Reading Agreement on Greenhouse Gas Emissions Trading. Brussels; *ENDS Daily* (25 June 2003), 'EU Climate Emissions Trading Breakthrough, Issue 1470; *Euractiv* (27 June 2003), 'EP and Member States find compromise on Greenhouse Gas Emissions Trading'.

**Table 5.4 ET proposal, Parliament proposals and final outcome**

	Type of system	Coverage/scope	Method of allocation	Compliance and enforcement
<b>Commission proposal October 2001</b>	Mandatory system, but decentralized setting of emission caps	Start with CO <sub>2</sub> only and four targeted 'activities' Opt-in of additional sectors and activities from 2008 on	Free of charge allocation in pilot phase; next phase to be decided in 2006 review	Penalty: either €50 (pilot phase)/ €100 (Kyoto phase) or twice the average market price – 'whichever is higher'
<b>Changes suggested in Parliament first reading</b>	Cap on total quantity of allowances to be allocated to each member-state	All six Kyoto gases Chemicals and aluminium sectors also included Temporary exemption/opt-out of individual installations Opt-in of additional sectors and activities already from 2005	Mandatory auctioning of 15% of allowances in both pilot and Kyoto phases	No changes suggested
<b>Changes suggested in Parliament second reading</b>	National ceiling/'cap' for emission allowances to prevent over-allocations, based on a linear curve consistent with the member-state's Kyoto commitments	Temporary and limited opt-outs for installations should be possible under three strict conditions The directive should be revised in 2006 to include other sectors, especially the transport sector	Method of allocating allowances should be harmonized, with allocation free of charge in pilot phase, and 5% auctioning from 2008	No changes suggested
<b>Final outcome: the ET directive</b>	Total amount of allowances should be 'consistent with a path towards achieving or over-achieving' Kyoto targets	Temporary opt-outs only for installations, but not for whole sectors The Commission to produce report on further broadening and development of the ETS to the Parliament and the Council by June 30 2006	At least 95% of the allowances to be allocated free of charge before 2008, and at least 90% after 2008	Penalty: €40 (pilot phase)/ €100 (Kyoto phase)

This outcome of the negotiations was then accepted by the Parliament in plenary on 2 July, at which time 17 amendments, mostly minor clarifications, were also adopted.<sup>119</sup> Only 4 votes were cast against the ET directive at this final reading (Vis 2006a, 40). On the whole, the Parliament's ET rapporteur da Silva was very satisfied with the outcome: 'With this agreement we both avoided a long conciliation procedure and we improved the integrity of the Directive. The scheme is now environmentally more ambitious, economically more efficient, with less distortions of competition and more compatible with national policies already being implemented'.<sup>120</sup> The Commission then expressed its formal opinion on the outcome on 18 July 2003, discussing and (not so surprisingly) accepting the 17 amendments adopted by the Parliament on 2 July.<sup>121</sup> The Council formally adopted the directive on 22 July 2003. As the final step in this part of the story, the ET Directive became formal EU law when it was published in the EU Official Journal on 25 October 2003.<sup>122</sup>

### *The Linking Directive*

As we concluded in the section on the member-state positions, the Linking Directive became noticeably influenced by member-state interests. The changes of the timing that CDM could not be used until 2008, the quantitative cap on JI/CDM credits as a percentage of the total quantity of member-state allowances, and to a lesser extent, the qualitative restrictions concerning sinks, nuclear and hydropower – all these can largely be credited to the positions of the member-states. However, also the EU institutions affected the design of this directive, which was adopted by the co-decision procedure, as the EU ET Directive.

The Commission's proposal for a linking directive was issued on 23 July 2003. As mentioned, it set no explicit quantitative cap on the import of JI and CDM credits, but suggested that the Commission should monitor the import. Once 6 per cent of the total quantity of member-state allowances had been reached, the Commission would review the situation and consider 'a maximum of for example 8%'. Concerning timing, the proposal allowed for CDM credits to be used in the ETS only from

119 European Parliament (2 July 2003), Greenhouse Gas Emission Allowance Trading, European Parliament Legislative Resolution on the Council Common Position with a View to Adopting a European Parliament and Council Directive Establishing a Scheme for Greenhouse Gas Emissions Allowance Trading within the Community and Amending Council Directive 96/61/EC (15792/2002-C5-0135/2003-2001/0245 (COD), P5\_TA/2003)0319.

120 *Point Carbon* (27 June 2003), 'Improved Integrity, says da Silva, *Point Carbon, Carbon Market Europe*, 2.

121 European Commission (18 July 2003), COM(2003)463 final, Opinion of the Commission pursuant to Article 251 (2), third subparagraph, point (c) of the EC Treaty, on the European Parliament's amendments to the Council's common position regarding the proposal for a Directive of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (Brussels).

122 *ENDS Daily* (30 October 2003), 'EU Emissions Trading Law Enters into Force', Issue 1542.

January 2008.<sup>123</sup> With regard to qualitative restrictions, credits resulting from nuclear projects were banned from use for an unspecified period, whereas the exclusion of sinks would be limited to the first Kyoto period. Credits from hydropower plants were to be allowed as long as they took 'account of environmental and social impacts'.

The Parliament demanded that the directive should be *at least* as restrictive as in the proposal. It seems as if, not having achieved what they wanted during the ET process, some MEPs now sought 'payback' in the form of tighter restrictions on the project mechanisms.<sup>124</sup> The ENGOS strongly opposed any link with the Kyoto Protocol's flexible mechanisms and would, as a second-best option, support any further restrictions to the proposal. The main argument used against linking between the EU ETS and the Kyoto Protocol's flexible mechanisms has been that it might weaken the incentives to reduce GHG emissions inside the EU. In contrast, a majority of EU member-states preferred less restrictions than proposed by the Commission, and industry generally preferred as few restrictions and as much linking as possible. The main argument for using CDM/JI for complying with targets under the EU ETS has been that the project-based mechanisms can reduce compliance costs by providing greater opportunities to reduce emissions outside the EU at lower costs.

The Commission had hoped to secure an agreement on the proposal as early as December 2003, but this timeframe would soon prove overly optimistic.<sup>125</sup> Not only did the proposal get a lukewarm reception from the Parliament and several member-states, the Commission was also internally divided on the issue (Michaelowa 2004, 13). The conflict was most apparent when an unfinished draft of the linking proposal was leaked by the Environment Directorate in June, resulting in internal dispute in the Commission, protests from industry and the delay of the official proposal.<sup>126</sup> This was hardly an ideal starting point for a Commission that wanted to exercise a 'smoothing' role in the upcoming negotiations.

The mood in the Council was quite different. Most ministers preferred establishing a link already from 2005, and they were against setting a quantitative limit altogether. As to qualitative restrictions, the ministers were more divided. France demanded acceptance for credits from nuclear projects throughout the process; and several states, particularly southern ones, wanted acceptance for sink credits. The differences were so severe that the linking negotiations basically stood still throughout 2003.

Two factors seem to have been decisive in getting the ball rolling again. First, there was the tactic manoeuvre by the Parliament's rapporteur Alexander de Roo. At various meetings in December 2003 he indicated that he wanted agreement on the proposal before the 2004 elections to the EP; and, for such agreement to be reached, the Parliament could be flexible on the cap if the qualitative provisions remained sufficiently robust (Lefevre 2006, 127). In other words, if a Council majority could

123 This despite of the fact that the Kyoto Protocol allowed the use of CDM credits before 2008.

124 *ENDS Report* (September 2003), 'The Clean Development Mechanism: Kyoto Comes Home to Roost', Issue 344.

125 *Ibid.*

126 *Environment Finance* (18 July 2003), 'Commission Axes Credit Cap in "linking directive"'; Michaelowa 2004, 13.

back restrictive rules on nuclear credits, sink credits and hydropower credits, a deal could be brokered on moderating the cap.

Then there was the time factor. If agreement were not reached before the end of April 2004, at which point the Parliament would dissolve for elections and summer hiatus, that would mean waiting until late 2004 or perhaps even till 2005 before any further progress could be made. A little push for speed in the negotiations could save six months or more. With the New Year, the Irish, who had just taken over the Presidency, promised to 'aim to secure agreement with the Parliament at first reading'.<sup>127</sup> And throughout the negotiations, the Presidency took care sure to remind the parties of their 'extremely tight timetable'.<sup>128</sup>

Both the time pressure and de Roo's proposal seemed to work. The proposed deal was reflected in the draft report from the EP Environment Committee in late January 2004,<sup>129</sup> and was further discussed at meetings of the Working Party on the Environment.<sup>130</sup> And, reported in the Council Minutes, during the spring there were several informal contacts between the Presidency and the rapporteur.<sup>131</sup> On 16 March the EP Environment Committee tabled a position containing 18 amendments to the Commission's original proposal. It suggested that the issue of a cap should be left to the member-states to decide, and also argued that credits should be available from 2005, instead of 2008, which would be good news for European industry. Campaigners saw the committee's vote as a 'pre-concession' prior to the negotiations:<sup>132</sup> the interests of the member-states and industry had already been taken into account. Rapporteur de Roo, however, having underlined the need for

<sup>127</sup> *Point Carbon* (7 January 2004), 'EU Institutions Hope to Clinch Linking Deal by May'.

<sup>128</sup> See for instance Council (4 March 2004), Note 6490/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Compromise Proposal. (Brussels: Council of the European Union, General Secretariat).

<sup>129</sup> European Parliament (27 January 2004), Draft report from the Committee on the Environment, Public Health and Consumer Policy.

<sup>130</sup> See, for instance, Council (6 February 2004), Note 5975/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms. (Brussels, Council of the European Union, General Secretariat).

<sup>131</sup> See Council (22 March 2004), Note 7652/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Examination of EP ENVI Committee Amendments with a View to a Possible First Reading Agreement with the EP (Brussels: Council of the European Union, General Secretariat); and Council (26 March 2004), Working Document 7844/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol's Project Mechanisms – Revised Presidency Compromise Proposal (Brussels: Council of the European Union, General Secretariat).

<sup>132</sup> *ENDS Daily* (16 March 2004), 'MEPs Yield to EU States in Kyoto Linking Cap'.

'robust' restrictions, was happy the Committee had managed to reject the efforts by centre-right MEPs to allow sink credits, and said the EU was now '99.9 per cent certain' to finalize the directive by April.<sup>133</sup>

De Roo's timing predictions proved correct. On April 5 the parties reached an informal agreement, trading off the demands of the Council (on timing and the cap) against the demands of the Parliament (on qualitative provisions).<sup>134</sup> On 20 April the deal was made official, when the Parliament, perhaps reflecting its eagerness to get the directive adopted before the summer deadline, approved the compromise package and thereby avoided time-consuming conciliation<sup>135</sup> – even if this left the final directive at quite a distance from what the Parliament had originally wanted.<sup>136</sup> There would be no common cap,<sup>137</sup> and CDM credits could be used from January 2005.

The Parliament's demands for solid qualitative restrictions were met only in part: whereas nuclear activities were excluded indefinitely in the original proposal, they were now explicitly excluded only till 2012 (due to pressure from France, as noted earlier). Sinks were also excluded only temporarily – possible inclusion for the first Kyoto commitment period would be reconsidered in 2006. Only with regard to hydro-projects was there a clearer regulation than in the original proposal: hydro-projects with capacity over 20MW would have to comply with the rules set by the World Commission on Dams.

In sum, although the Parliament and rapporteur De Roo stand out as skilful players taking on a responsible and more comprehensive EU perspective in an atmosphere of urgency, the Parliament paid a high price in terms of concessions. Only in the case of big hydro-projects did it manage to nudge the proposal in a more restrictive direction. Furthermore, since the Commission's initial proposal was changed substantially, the Commission must be said to be less successful than in the case of the EU ET Directive. This may be traced back to the fact that the Commission was more split on this issue. In addition, there seems to have been a closer match between the position of a majority of the member-states and industry in the linking case, as compared to the foregoing EU ETS process. With the time factor, the EU institutions had to give in and accept linking with few restrictions.

### Conclusion

In Chapter 2, we proposed that the final ETS would reflect the positions of the Commission and the Parliament, according to the EU institutional perspective. As a first observation in relation to this proposition, we may conclude that key elements of the Commission's proposal for an ET directive managed to survive the

<sup>133</sup> *Ibid.*

<sup>134</sup> Lefevre 2006, 127; *ENDS Daily* (14 September 2004), 'Ministers Adopt EU Kyoto Linking Law'.

<sup>135</sup> Only a few MEPs from the UK Independent Party voted against it.

<sup>136</sup> European Parliament (20 April 2004), Position of the European Parliament.

<sup>137</sup> It was, however, warned that the Commission could make proposals following its mid-2006 review to harmonize the member-states' caps.



numerous twists and turns of the decision-making process. The overall approach on harmonization and centralized control leaned towards the decentralized side, with no harmonization and centrally set caps on the quantities of allowances issued. Furthermore, the system laid out in the ET directive was a mandatory system. The initial system would target only CO<sub>2</sub>; sectoral coverage, in terms of activities listed in the directive, was identical to the Commission's proposal. Allocation free of charge was the dominant allocation method in the pilot phase 2005–07. The penalty level for non-compliance in the directive was roughly similar in the pilot phase (€40 instead of the proposed €50), and identical in the Kyoto commitment period (€100). The main design of the links between the EU ETS and Kyoto Protocol's flexible mechanisms would be settled in a subsequent, separate directive.

Hence, it is tempting to jump to the conclusion that the Commission, through its proposal, essentially determined the final EU ETS design. As pointed out in the section on member-state positions, however, the actual and anticipated diversity in the interests of the majority of the member-states was to a significant extent taken into account in the Commission proposal. Moreover, some changes *were* actually made by the member-states in the course of the decision-making process. Nevertheless, the Commission continued to play an important role in the decision-making phase: by arguing against many of the EP proposals, by providing information, and generally on the basis of its formal position in the co-decision procedure.

The Parliament has more formal power in the decision-making process than the Commission, but not necessarily more actual influence. The EP's influence on the final directive was moderate. The main changes to the proposed ET directive that can be attributed to the Parliament include prevention of opt-out of sectors; explicit mention of the chemicals, aluminium and transport sectors for future inclusion; and a limited opening up for allocation by auctioning. In addition, with regard to the Linking Directive, the EP obtained an inclusion of reference to rules set by the World Commission on Dams concerning hydropower projects.

As discussed earlier, the moderate impact was due to resistance from the Commission; furthermore, on major issues the Parliament was up against an 'alliance' between the Commission, a majority of member-states and industry; and there were too many proposals and hence a lack of focal points. The Commission and the BEST group continued to play a vital and active role in the process, by giving formal comments along the way, and providing more informal support in connection with the process of hammering out the Council's common position. In addition, the second reading shows that the time factor became important. In the final spurt the Parliament was very reluctant to end up as the one left holding the bag, the one who wrecked the ambitious timetable and delayed the start-up of the scheme. Let us now see how the international climate regime contributed to make the time factor so (increasingly) important in the decision-making process.

### The International Climate Regime Context

To what extent and how did the international climate regime affect the EU ETS decision-making process? More specifically, how did the climate regime affect

the adoption and design of the EU ETS? In Chapter 2, we argued that political attention in the decision-making phase is likely to be directed internally, towards EU institutions and actors with a formal role to play in the decision-making process. However, significant changes in the institutional context may penetrate and affect internal decision-making process under certain conditions like 'shocks' and 'crisis'. Under such conditions, we surmised, the EU ETS might be affected by developments within the climate regime. As we shall see below, the US withdrawal from the Kyoto Protocol and subsequent uncertainty about ratification of the Protocol significantly affected the EU ETS decision-making process.

### US Exit from Kyoto

Something had changed, from the March 2000 Green Paper to the consultation process with member-states in September 2001. In 2000, the member-states disagreed on most aspects related to the design and harmonization of emission trading. And yet, in 2001, a majority of the member-states agreed on the basic design. Likewise, the consultation processes with industry and ENGOs showed an 'overwhelming majority' in favour of proceeding with emissions trading, sooner rather than later. The most important change to take place in this period was the decision by President George W. Bush to withdraw the USA from the Kyoto Protocol. This decision made entry into force of the Kyoto Protocol uncertain, as the Protocol requires ratification by 55 Parties accounting for at least 55 per cent of 1990 CO<sub>2</sub> emissions from that group. The US alone accounted for 34 per cent of Annex 1 1990 emissions. As we shall see below, the US withdrawal from the Kyoto Protocol served to make the EU ETS into an instrument that could rescue the Protocol.

The first indication that the Bush administration was reconsidering its position on the Kyoto Protocol came at the time the Commission started drafting the ET directive, shortly after the inauguration of the new US administration in January 2001. After the failure to finalize the rules of the Kyoto Protocol at CoP-6 in The Hague in November 2000, a new global effort was scheduled for Bonn in May 2001. The new US government wanted to postpone the conference until July. The official reason given was that that new administration needed time to review its global climate policy.<sup>138</sup> The EU reluctantly acceded to the US demand.

In March 2001, Bush announced his opposition to the Kyoto Protocol, arguing that it exempted developing countries, would cause serious harm to the US economy and was based on incomplete scientific knowledge. These statements were followed up by the head of the US Environmental Protection Agency (EPA) and substantiated by a decision not to limit power-station CO<sub>2</sub> emissions as promised during the election campaign.<sup>139</sup> The US decision to withdraw from the Kyoto Protocol might have been foreseen even though President Clinton had signed the Kyoto agreement in 1998. Prior to the Kyoto negotiations, the US Senate had delivered a clear message

<sup>138</sup> *ENDS Daily* (25 January 2001), 'USA Demands Further Delay in Climate Talks', Issue 917.

<sup>139</sup> *ENDS Daily* (14 March 2001), 'EU Spooked by Bush U-turn on CO<sub>2</sub> Limits', Issue 951.

to the Clinton-Gore administration. In a unanimous 95–0 vote, the Senate stated that it would not accept several of the conditions codified in the Kyoto Protocol. It voted against any treaty that would exempt developing countries from legally binding commitments and imply higher energy costs, particularly on petrol (the Byrd-Hagel resolution of 25 July 1997). For the Kyoto Protocol to be ratified by the US Senate, and thus become US law, it would have to receive 67 out of 100 senatorial votes.

Prior to the 2000 elections, the democratic candidate, Vice-President Al Gore, would probably put all his political weight into persuading the Senate to ratify. However, Gore had low standing in the Senate and would in any case face considerable opposition. The Republican candidate, George W. Bush, would enjoy higher standing in the Senate, but would not push for ratification. If the US had ratified the Kyoto Protocol, the US target under the Protocol, of reducing its emissions by 7 per cent compared to 1990 levels within the period 2008–12, would still be out of reach.<sup>140</sup> This would require dramatic domestic cutbacks combined with anticipated time-consuming legal action initiated by industry and environmental groups against the EPA. The perception among major US companies and other stakeholders was thus that the Protocol was ‘dead on arrival’ (Skjærseth and Skodvin 2003). With the benefit of hindsight, we can say that the US withdrawal should have come as no surprise.

For the EU, however, the US withdrawal from the Kyoto Protocol was unexpected, although there had always been concern about US ratification. In February 2001, for example, Danish environment minister Svend Auken had suggested that ideally the Kyoto Protocol should be renegotiated to bridge the gap between the EU and the USA. He sympathized with a WWF-Denmark proposal to allow the USA to stabilize its GHG emissions at 1990 levels by 2008–12 rather than its commitment to a 7 per cent cut.<sup>141</sup> Representatives of the European Commission saw the US decision as ‘a blow’ which led to a sense of crisis.<sup>142</sup>

The US decision to dump the Kyoto Protocol was taken very seriously by the top EU leaders, who responded immediately. In a letter to Bush, Romano Prodi (President of the European Commission) and Swedish Prime Minister Göran Persson (acting in capacity of the Swedish EU Presidency) urged a high-level meeting to discuss the future of the Kyoto Protocol. The European Council followed this up in a resolution from the March 2001 Stockholm summit, expressing its deep concern regarding the fate of the Protocol. And Environment Commissioner Margot Wallström led a high-level delegation to Washington to clarify the US position. It received a clear answer:

140 Since 1990, US emissions had increased by over 14 per cent, and were expected to increase by at least 1 per cent each year for the next decade. This meant that emissions would have to be reduced by more than 30 per cent during the agreement period. The Kyoto Protocol allows for emissions trading, but many doubted the political realism of the USA becoming a major buyer of quotas from Russia. Even if large-scale quota-buying could come about, powerful domestic measures would still be needed to achieve reductions in the order of 30 per cent.

141 *ENDS Daily* (26 February 2001), ‘Auken Calls for All-out Action on Climate’, Issue 939.

142 Interviews in Brussels, 12 January and 15 May 2006.

the USA would not ratify.<sup>143</sup> Despite the negative signals from Washington, the EU decided to continue with its preparations for the resumed CoP-6 in Bonn in July.

The consequences of the US exit for the proposed ET directive could go in two opposite directions. First, it could strengthen the arguments of actors sceptical or opposed to emissions trading at the European level. A regulative restriction on carbon emissions in Europe could weaken the competitive situation for European companies in relation to the USA and the OECD. Without US ratification, almost all other major emitters in the industrialized world (Japan, Canada) plus countries with economies in transition (Central/Eastern Europe and Russia) would have to ratify. The Bush administration thus referred to the agreement as ‘dead’ after his decision to withdraw (Schreurs 2004, 208). The US exit could effectively undermine the growing support for the proposed ET directive unless enough other countries agreed to ratify.<sup>144</sup> Particularly Germany and German industry was not – to say the least – particularly enthusiastic about the Commission’s plans of a cap-and-trade system at EU level. The dilemma for Germany was that the EU ETS became an important part of the ‘save the Kyoto’ campaign. And some European industries exposed to significant international competition actually used the US exit to argue against the plans for a cap-and-trade system.<sup>145</sup> Such arguments drowned, however, in the unifying effect.

The second and chief effect of the US rejection of the Kyoto Protocol was that it helped unify the actors and institutions involved in developing EU climate policy. As noted by Brussels insiders, ‘the huge impetus the Commission used was Bush’s withdrawal. It united the EU in an extraordinary way’.<sup>146</sup> Romano Prodi and Göran Persson said in a statement that it was ‘shocking to European ears’ that the USA did not intend to make any effort to tackle climate change unless other countries with fewer resources did so.<sup>147</sup> According to Schreurs (2004, 209): ‘The Bush decision (...) so angered the Europeans that they were able to overcome internal disagreements and present a strong united block supporting the Kyoto Protocol ... Seldom in history has the EU criticized the US as forcefully as it has over this issue’. Furthermore: ‘In the subsequent months [after the US exit] climate change and the Kyoto Protocol became defining issues for the European Union, and importantly, issues on which it was united, and one on which it saw itself at the forefront of the international efforts. Public opinion was supportive of such a stance’ (Vis 2006a, 40). This effect extended far beyond the EU, and facilitated broad international support for the Protocol (Yamin 2005b).

More specifically, the US withdrawal unified positions and increased the support for the EU ETS from member-states, industry, ENGOs and probably within the Commission itself as well. Suddenly, the relationship between the EU and the USA

143 *ENDS Daily* (4 April 2001), ‘Washington Climate Talks Leave EU Disappointed’, Issue 966.

144 Strictly legally speaking, however, the proposed ET directive was deliberately not made conditional upon the entry into force of the Kyoto Protocol.

145 Interviews in Brussels, 15 May 2006.

146 Interviews in Brussels, 26–27 May 2004.

147 *ENDS Daily* (10 April 2001), ‘EU Claims Global Support for Kyoto’, Issue 970.

over climate policy became high politics. According to the statement by the EU Heads of State at their summit in Gothenberg in June 2001, which coincided with the EU-US summit attended by George W. Bush: 'the Community and the Member-states are determined to meet their commitments under the Kyoto Protocol' and reaffirm their 'commitment to deliver on the Kyoto targets' (Slingenberg 2006, 33).

The US withdrawal from the Kyoto Protocol made the Commission significantly advance its agenda on the ET directive proposal. In March 2001, the EU Environment Council singled out the work based on the Green Paper on emissions trading as 'of particular importance' for the EU's efforts to combat climate change.<sup>148</sup> As noted earlier, Environment Commissioner Wallström instructed the Climate Change Unit to prepare the draft directive to be adopted by the Commission before CoP-6 in Bonn, to show the outside world that the EU was still taking the Kyoto Protocol seriously. The US exit did not, however, affect the design of the planned ET scheme, as the main structure of the ET directive proposal was well advanced by March 2001.

The Commission had the tools to make the 'save Kyoto campaign' credible to other major industrial emitters by preparing for emissions trading. According to Vis (2006a, 40): 'Emissions trading came to be seen as the practical measure that would test the credibility of the EU's promises to act'. The Proposal for an ET directive was depicted as the key measure for implementing the Kyoto Protocol; a direct linkage was made to efforts to save the Kyoto Protocol by accompanying the ET directive proposal with a proposal for a Council Decision to ratify the Kyoto Protocol.<sup>149</sup> This move increased support for the directive in the Council of Ministers, which had declared their determination to ratify the Protocol. In this way, EU implementation of the Kyoto commitments became deliberately linked to the ratification of the Kyoto Protocol. The US rejection thus placed the draft ET proposal in the spotlight and raised emissions trading to the top of the EU agenda. This was perceived by the Climate Change Unit in the Commission as a 'window of opportunity' for realizing plans for a European emissions trading system, and for the EU to show leadership in global climate diplomacy.<sup>150</sup>

The EU's leadership ambition expressed itself in diplomatic efforts to win the support of other states to ratify the Kyoto Protocol. Shortly after Bush's announcement that the US would reject the Kyoto Protocol, the Swedish President of the Environment Council declared that EU would ratify the Kyoto Protocol, with or without the USA. Ratification by the EU was timed to occur prior to the 2002 Johannesburg summit. A statement adopted unanimously by all EU environmental ministers read: 'The Kyoto Protocol is still alive – no individual country has the right to declare a multilateral agreement as dead'.<sup>151</sup> This declaration was reaffirmed at the Environment Council meeting in June 2001: 'The European Union maintains the

148 Council (8 March 2001), 6752/01, 2334<sup>th</sup> Council Meeting Environment. Presse 93, 2001, Brussels, 5.

149 A communication on implementing the European Climate Change Programme was also presented. Council (29 October 2001), 12994/01, 2378<sup>th</sup> Council Meeting Environment. Presse 372, 2001. Luxembourg.

150 Interviews in Brussels, 12 January and 15 May 2006.

151 *ENDS Daily* (2 April 2001), 'EU "Will Ratify Kyoto without USA"', Issue 964.

target of ratification and entry into force of the Kyoto protocol by 2002, striving for the broadest possible participation of Annex I countries, and to that end the European Community and its member-states have started their internal preparations'.<sup>152</sup>

EU environmental leaders representing the Council and the Commission immediately visited Canada, Russia, Japan and other countries to garner support for the Protocol and ensure them that the EU was determined to ratify. This response surprised the Bush administration, which had expected that the EU would simply join the USA in abandoning the agreement (Schreurs 2004, 209). Had that happened, then the EU ETS could have been abandoned as well: if the Kyoto Protocol had collapsed, it would most probably have been detrimental to the outcome of the EU ETS decision-making process.

The fact that the US exit from the Kyoto Protocol provoked the EU and served to strengthen its determination to push for ratification of the Kyoto Protocol and the EU ETS should be understood in a historical context. Since 1990, the EU has aimed at leadership in global climate diplomacy. The EU adopted a stabilization target as early as in 1990 and argued for binding reduction targets in the UNFCCC concluded at the 1992 Rio summit (see Chapter 1). The EU's position was significantly more ambitious than that of the USA, and reflected different constellations of interests, access to decision-making, principles and regulatory cultures across the Atlantic (Schreurs 2004).

Although the gap narrowed somewhat during the Clinton Administration, the EU, led by Germany, was the main driving force behind the 'Berlin Mandate' and the binding commitments agreed in Kyoto, even though the EU preferred more ambitious targets, more domestic efforts and less flexibility. The time and energy invested by the EU in moving international commitments toward quantified and binding reduction objectives indicate a definite commitment to follow through.

The strong EU reaction was also not so surprising in light of new and more alarming conclusions presented by the Third Assessment Report of the Intergovernmental Panel on Climate Change, which indicated a more rapid rise in temperatures than previously feared, and with significant impacts. Parts of this report were published shortly before Bush's decision to withdraw. In a response, the EU Environment Council concluded: 'The Council takes seriously the emerging conclusions of the Third Assessment Report of the IPCC, which confirm and reinforce that need for urgent action to tackle climate change'.<sup>153</sup> This perception was strengthened later (in October 2002): 'The Council REITERATES its deep concern about the robust findings in the TAR [Third Assessment Report], and NOTES with deep concern the important message of the IPCC that human interference with the climate system carries a risk of triggering irreversible or abrupt changes'.<sup>154</sup>

152 Council (7 June 2001), 9116/01, 2355<sup>th</sup> Council Meeting Environment. Presse 201, 2001. Brussels, 12.

153 Council (8 March 2001), 6752/01, 2334<sup>th</sup> Council Meeting Environment. Presse 93, 2001. Brussels, 5.

154 Council (17 October 2002), 12976/02, 2457<sup>th</sup> Council Meeting Environment. Presse-320, 2002. Luxembourg, 17.

The new US programme on climate change strategy was not published until February 2002, and the EU Environment Council discussed the US programme in March 2002. While confirming that the EU was willing to continue dialogue with the USA, the Council concluded:

having studied the initiative on climate change presented by President Bush on 14 February 2002, [the Council] is concerned about the proposed measures, which allow an increase of greenhouse gas emissions at nearly the same rate as at present and are not sufficient effectively to fight climate change...calls upon the parties to the United Nations Framework Convention on Climate Change, including the United States of America, the biggest emitter of greenhouse gases, to live up to their responsibility under this Convention, which requires industrialized countries to return their greenhouse gas emissions to 1990 levels.<sup>155</sup>

*Proposing the ET directive: Bonn and Marrakech*

The US rejection of the Kyoto Protocol also led the EU to accept significant modifications during the Bonn negotiations, in order to ensure the support of important states like Japan. The survival of the Protocol itself during 2001 became crucial for the rapid progress of the ET Directive.

The purpose of CoP-6 in The Hague in November 2000 was to implement the Buenos Aires Plan of Action, paving the way for the entry into force of the Kyoto Protocol. CoP-6 negotiations collapsed due to disagreement on several issues, including whether a cap should be placed on the use of flexible mechanisms.<sup>156</sup> The EU preferred that at least 50 per cent of emissions reductions should be achieved by domestic policies and measures, whereas the USA insisted that there should be no limits on their use. However, during the negotiations there were signs that the EU was willing to relax its emphasis on quantitative caps in favour of a qualitative limit on the use of the flexible mechanisms.<sup>157</sup> The EU argued that if there were no limits on the use of the flexible mechanisms, that would threaten the environmental integrity of the Protocol by allowing 'loopholes' regarding domestic attainment of the agreed targets. Delegates agreed to suspend CoP-6 and to resume their work in 2001. Against this background and the US announcement to reject the Kyoto Protocol, the EU developed its position through various preparatory meetings for the resumed CoP-6 in Bonn in July.

The general EU position was made clear at the June 2001 meeting of the EU Environment Council:

The European Union is ready to negotiate in a constructive spirit with all partners on all outstanding issue in Bonn. While we are prepared for compromises, we consider it essential to underline the importance of the fundamental elements of the FCCC and the Kyoto

<sup>155</sup> Council (4 March 2002), 6592/02, 2413th Council Meeting Environment. Presse 47, 2002. Brussels, 5.

<sup>156</sup> The other issues were 'sinks', funding and compliance.

<sup>157</sup> *Earth Negotiations Bulletin* (27 November 2000), 'Summary of the Sixth Conference of the Parties to the Framework Convention on Climate Change: 13-25 November 2000', 12:163.

Protocol, including the legally binding emission limitation and reduction commitments, in order to ensure a long-term sustainable global climate policy. The Council reiterates that any agreement must safeguard the environmental integrity, must lead to real reduction in greenhouse gas emissions, and be supported by a credible compliance and liability system.<sup>158</sup>

While emphasizing the environmental integrity of the Protocol, the Ministers did not explicitly mention the previous insistence on a cap on the use of the flexible mechanisms. In Bonn, the EU and Japan became the major players, with the USA on the sidelines. The US delegation had committed not to interfere with the talks, whereas Japan's position was crucial to fulfilling the conditions for the Protocol to come into force. Moreover, Japan pledged to try – 'to the last minute' – to persuade Washington to reconsider its position.<sup>159</sup>

The agreement in Bonn on outstanding issues came as a surprise to most observers. But the price was high, as the EU had to yield on several issues. No quantitative cap was placed on industrialized countries regarding the use of flexible mechanisms to meet their emission targets. In line with the Kyoto Protocol, however, the flexible mechanisms were to be supplemental to domestic action, which should constitute a significant element of the reduction effort. Rules were also agreed on compliance, 'sinks' and funding.<sup>160</sup> From an environmental integrity perspective, the agreement reached at the inclusion of sinks has been deemed a major setback (Yamin 2005b, 8).<sup>161</sup> The rulebook was agreed at CoP-7 in Marrakech in October 2001.

The agreement in Bonn and Marrakech strengthened the Commission's determination to adopt the proposal for an ET directive by the end of 2001. As the EU ETS was depicted as the key measure for implementing the Kyoto Protocol, ensuring the survival of the Protocol itself became crucial to the rapid proposal and adoption of the ET Directive. The rules for international emissions trading agreed in Bonn and Marrakech did not, however, significantly affect the design of the EU ETS, as the proposed ET directive was directed towards companies, nor governments, and the main structure of the proposal was ready before these conferences. The Commission worked to ensure compatibility between the international emissions trading system and the EU trading system. In practice, the Commission has had an important say in the development of EU positions in the international climate negotiations even though the Council formally adopts its position prior to or during the CoPs (Slingenbergh 2006, 23). The EU is represented in negotiations by a troika: the country currently holding the Presidency, the country next in line, and the

<sup>158</sup> Council (7 June 2001), 9116/01, 2355<sup>th</sup> Council Meeting Environment. Presse 201, 2001. Brussels, 11.

<sup>159</sup> *ENDS Daily* (16 July 2001), 'Global Climate Talks Reopen in Bonn', Issue 1031.

<sup>160</sup> *Earth Negotiations Bulletin* (176, 2001), Summary of the Resumed Sixth Session of the Conference of the Parties to the UN Framework Convention on Climate Change: 16-27 July, 2001', 12:176; *ENDS Daily* (23 July 2001), 'Kyoto Protocol Rulebook in Summary, Issue 1036.

<sup>161</sup> The availability of sinks is important for the degree to which each country has to reduce GHG emissions.



Commission. Since the CoPs take place every year, the Commission is the stable factor in the EU's participation in international negotiations (*ibid.*).

Jos Delbeke and the BEST team served as the chief negotiator for the European Commission at the UNFCCC Conference of the Parties. The climate change unit in DG Environment participated in all Conferences of the Parties to the UN Framework Convention on Climate Change and guarded the EU emission trading plans. The Commission would have opposed any proposals for amendments in the international system that did not fit with the plans for the EU system.<sup>162</sup> In conclusion, then, we may say that the US rejection caused the EU to make significant sacrifices to reach agreement in Bonn and Marrakech. The agreement that was reached served to strengthen the EU's determination to adopt the proposed ET directive in 2001. However, these international events did not significantly affect the design of the proposed ET directive.

#### *Other External US Influence*

As noted earlier, a broad range of EU internal stakeholders actually lobbied the European Parliament to accept the common position in the Council of Ministers. Concurrently, external lobby groups representing the traditional interests of the fossil fuel lobby did what they could to sink the Kyoto Protocol and the EU ETS.

Whereas Washington honoured its commitment not to interfere with the negotiation in Bonn, private US interests lobbied intensively against ratification of the Kyoto Protocol and the emerging EU ETS. Shortly after the ET directive was proposed, the American Council for Capital Formation (ACCF) published studies predicting adverse consequences for the European economy and employment that would accrue if Kyoto Protocol targets were to be met by emissions trading. Founded in 1973, the ACCF is a US based think-tank and lobby organization with an affiliate in Brussels, the International Council for Capital Formation (ICCF) led by Managing Director Margo Thorning. The climate policy of ACCF/ICCF appears as a blueprint of the climate policy of the Bush administration: 'The ACCF makes the case that, given the need to maintain strong U.S. economic growth and energy security, policy-makers should develop a flexible long term approach ... based on technological innovation ... and bilateral cooperation with developing countries'.<sup>163</sup> In its climate policy studies, ACCF stresses the high costs and ineffectiveness of emissions trading and mandatory carbon-emission reduction targets.

The ACCF is funded by corporations, associations and foundations and allocates about 25 per cent of its expenditures to influencing legislation.<sup>164</sup> Representatives of major US industry federations like the American Petroleum Institute (API) sit on the Board of Directors. The lobby campaign in Brussels was undertaken primarily on behalf of US-based multinational companies with significant operations in Europe

<sup>162</sup> Interviews in Brussels, 15 May 2006.

<sup>163</sup> American Council for Capital Formation, 'ACCF Climate Change Studies and Reports' [website] <<http://www.accf.org/climate/cc-papers.html>>, accessed 15 June 2007.

<sup>164</sup> American Council for Capital Formation, 'About ACCF, ACCF Mission' [website] <<http://www.accf.org/about/index.html>>, accessed 15 June 2007.

that would be affected by the EU ETS.<sup>165</sup> API and particularly ExxonMobil – the biggest private oil company in the world – lobbied intensively against any mandatory climate policy, the Kyoto Protocol in particular (Skjærseth and Skodvin 2003). From the 2000 Green Paper on emissions trading, refining was included as one of the sectors to be included in the EU ETS. ExxonMobil is the second-largest crude oil refiner in Europe, with interests in 11 major refineries.<sup>166</sup>

ACCF reports on the adverse consequences of the climate policy of the EU were taken seriously at the top level in the Commission. The ACCF argued that the allowance prices needed to reach the Kyoto target would lead to 3.8–5.2 per cent lower GDP in 2010 in Germany, Spain, the UK and the Netherlands. In turn, Environment Commissioner Wallström defended the ET proposal by referring to the Commission's own work showing that the costs could be as low as 0.06 per cent of expected GDP in 2010, adding that the ACCF studies were 'far off conventional wisdom'.<sup>167</sup> According to the Commission, the IPCC had forecast a range of 0.1 to 2 per cent of GDP.<sup>168</sup> The ACCF organized meetings with European industrial federations, the European Parliament, EU member-states and the Commission to influence the fate of the Kyoto Protocol and the EU ETS. The lobby campaign was mainly perceived as 'aggressive', 'crude' and 'counterproductive'.<sup>169</sup> The premises for the arguments produced by the ACCF were successfully attacked by the Commission and not picked up by major European industry federations like UNICE. The effect of ACCF's lobby campaign against the Kyoto Protocol and the proposed ET directive was thus limited. Still, it added to the numerous stumbling blocks that had to be overcome by the EU.

#### *Ratification of the Kyoto Protocol*

There was a real risk that the Kyoto Protocol could collapse from the time of the first ET directive proposal to the adoption of the final ET Directive. In March 2002, the Environment Council reached an agreement to ratify the Kyoto Protocol.<sup>170</sup> This agreement was formalized as a Council Decision in April and, together with ratification from member-states, aimed at enabling the Kyoto Protocol to enter into

<sup>165</sup> *ENDS Daily* (13 September 2002), 'Transatlantic Climate Cost Dispute Rumbles On', Issue 1286.

<sup>166</sup> Six refineries are fully owned and operated and three more are operated by ExxonMobil as majority shareholder. ExxonMobil, 'Our Business in Europe' [website] <[http://www.exxonmobil.com/Europe-English/About/Eu\\_AC\\_Business.asp](http://www.exxonmobil.com/Europe-English/About/Eu_AC_Business.asp)>, accessed 15 June 2007.

<sup>167</sup> *ENDS Daily* (12 July 2002), 'EU Climate Change Cost Estimates Disputed', Issue 1256.

<sup>168</sup> The ACCF was criticized by the Commission for looking only at carbon dioxide and not the other Kyoto gases, and for using a model normally employed for assessing only short-term economic consequences. *ENDS Daily* (13 September 2002), 'Transatlantic Climate Cost Dispute Rumbles On', Issue 1286.

<sup>169</sup> Interviews in Brussels, 15–16 May 2006.

<sup>170</sup> Council (4 March 2002), 6592/02, 2413<sup>th</sup> Council Meeting Environment. Presse 47, 2002. Brussels.

force before the Johannesburg World Summit in September 2002 – which, however, it did not. The Decision also included the 1998 Burden-sharing Agreement between the member-states aimed at joint reduction of 8 per cent of GHG emissions<sup>171</sup> – to apply irrespective of whether or not the Kyoto Protocol entered into force. In legal terms, this means that the member-states' obligations in the Burden-sharing Agreement were not conditional upon the entry into force of the Kyoto Protocol.

Nevertheless, continuing uncertainty about ratification of the Kyoto Protocol after 2001 affected the EU ETS decision-making process. It meant that the Commission was initially extremely careful not to link the EU ETS inextricably to the Kyoto Protocol. In the Commission's original Articles on the ET directive proposal, there was only one reference to the Kyoto Protocol – in Article 19 on registries (Vis 2006b, 200). Throughout the negotiations, the Commission was careful to avoid making the EU ETS conditional on the entry into force of the Protocol (ibid.). Nevertheless, Annex III to the ET Directive stipulated that National Allocation Plans should 'be on a path towards meeting Kyoto targets' in the first period (2005–07) and 'consistent with the Kyoto targets' in the second period (2008–12). Moreover, the link between the EU ETS and the Kyoto Protocol's flexible mechanisms (CDM and JI) would not make much sense unless these mechanisms were part of the Protocol (see below).

For the Protocol to enter into force it would, as noted, have to be ratified by 55 contracting Parties accounting for 55 per cent of total carbon dioxide emissions as of 1990. Since most other states took steps to ratify the Protocol in 2002 – nearly 100 countries, including Japan and Canada – the US exit from the Kyoto Protocol left Russia in a key role for determining the fate of the Kyoto Protocol. In April 2002, statements by Russian Prime Minister Kasyanov were interpreted by the EU as a promise of ratification (Moe, forthcoming 2007). This interpretation was based on the opinion that Russia stood to gain from the Kyoto Protocol, even without the USA as a major buyer. Russia could sell its 'hot air' (unused assigned amounts) to parties facing problems with meeting their targets. Russian 'hot air' was, as previously noted, caused by the economic slowdown and restructuring which led to rapidly falling CO<sub>2</sub> emissions until the late 1990s. The EU conviction that Russia would ratify was important for keeping the final stage of the EU ETS decision-making process on track as the central element for complying with the Kyoto Protocol.

Things did not go as smoothly as expected, however, and doubts about Russian ratification increased in 2003. In September, Vladimir Putin was expected to decide on ratification, but he failed to give a clear signal, saying only that the government would take a decision in conformity with Russian national interests after studying the economic and social impact of Kyoto.<sup>172</sup> In December, the Protocol was again proclaimed 'dead', following statements by an economic advisor to Putin.<sup>173</sup> European Commission President Romano Prodi stated 'We are confident that Russia will ratify the Protocol so it can enter into force', but this perception was not shared

<sup>171</sup> Ibid.

<sup>172</sup> *ENDS Daily* (29 September 2003), 'Worries over Kyoto Mount as Russia Wavers', Issue 1519.

<sup>173</sup> *ENDS Daily* (3 December 2003), 'New Russian Scare for Kyoto Protocol', Issue 1566.

by all member-states.<sup>174</sup> Spain's initial problems with implementing its National Allocation Plan have been directly related to uncertainty about Russian ratification. According to Vis (2006b, 210), the Aznar government did not appear to take the Kyoto commitments seriously enough, 'perhaps in the belief that Russia would never ratify the Kyoto Protocol'. Russian ratification was in fact not as obvious as many in the EU appeared to think.

According to Moe (forthcoming 2007), Russia hesitated for three main reasons. First, there was lack of scientific consensus on the climate issue within Russia. Second, there was disagreement on economic effects, particularly whether the Kyoto Protocol might stifle economic growth in the long term. Third, there was rivalry between state agencies for control over implementation of Russian climate policy, as well as competition between potential sellers of emission quotas and between recipients of investments in joint implementation projects. Finally, however, in September 2004 the Russian government proposed ratification to the Duma, and the assembly ratified the Protocol in October. Russia's ratification can be explained by issue linkages: EU support for future Russian membership in the World Trade Organization had become linked to Russian ratification of the Kyoto Protocol (Slingenberg 2006, 21; Moe forthcoming 2007).<sup>175</sup> The Kyoto Protocol entered into force on 16 February 2005, giving more weight to the ET Directive and the National Allocation Plans 'on a path towards meeting Kyoto targets'.

#### *The Linking Directive*

Negotiations on the EU Linking Directive were also related to ratification of the Kyoto Protocol. One day before the launch of the linking proposal, Environment Commissioner Margot Wallström commented that she thought the proposal would be beneficial to 'other countries, for example Russia'.<sup>176</sup> This mention was far from a random remark, as Russia had the casting vote in determining whether the Protocol would be implemented. It was now up to the EU to convince Russia to ratify.<sup>177</sup> The Linking Directive was clearly part of these attempts: As one EU commissioner commented, 'the EU wants the Kyoto to enter into force, and this [linking] proposal gives an even bigger incentive for countries to ratify it'.<sup>178</sup> Like the EU ETS, the Linking Directive also became a tool for getting the Kyoto Protocol ratified.

<sup>174</sup> *ENDS Daily* (17 December 2003), 'Prodi Tries to Hold the Line on Kyoto Protocol', Issue 1576.

<sup>175</sup> Although the EU has officially rejected the link between trade and climate, the two issues were discussed in parallel at an EU-Russia summit in May 2004 (Moe, forthcoming 2007).

<sup>176</sup> *ENDS Daily* (24 July 2003), 'EU Injects Kyoto Flex-mex into Climate Trading', Issue 1488.

<sup>177</sup> See for instance: *ENDS Daily*, ibid.; *Point Carbon* (23 July 2003), 'Draft EU ETS Amendment on JI and CDM Published (European Commission)'; Reuters/Planetark (28 May 2003), 'EU to Link Emissions Trading to the Rest of the World'.

<sup>178</sup> *Point Carbon* (8 August 2003), 'Linking Proposal Aims to Provide Companies with More Options'.

Does this mean that Russia influenced the final content and the design of the Linking Directive? It could be argued that the Russians got their way in connection with the cap issue. At a roundtable discussion on air quality and climate change in Rome in March 2004, Russian participants had voiced their concern that the EU would cap the number of credits allowed into the EU ETS – and they had equally made it clear that without an expanded market for emission credits, Russia would not ratify the Kyoto Protocol.<sup>179</sup> As we know, the final directive contained no common cap on JI and CDM credits. However, there are also reasons not to exaggerate the Russian influence. In the course of the directive process, reference to the entry into force of the Kyoto Protocol was specifically deleted,<sup>180</sup> making the directive – at least formally – independent of Russia and the fate of the Protocol. As EP rapporteur Alexander de Roo commented, ‘this gives the message: We are not waiting for you, President Putin. We are going ahead with or without you’.<sup>181</sup>

Direct influence or not, the two processes were apparently interrelated. Only a month after agreement was reached on the Linking Directive (April 2004), Putin promised he would speed up work ‘towards ratification’.<sup>182</sup> Similarly, one month after the Linking Directive entered into force, Russia ratified the Protocol.

### Conclusion

To what extent, how and why did the relevant actors and institutions affect the final outcome of EU ETS? In this chapter, we have examined the influence of the EU member-states and institutions, as well as developments within the climate regime, on the EU ETS decision-making process.

Our first proposition stated that the EU ETS came to reflect the positions of the member-states as a result of interstate bargaining. In Chapter 3, we saw that the EU ETS underwent relatively little change from the ET directive proposal in 2001 to its final adoption in 2003. This suggests that the positions of the member-states changed, that their interests had already been taken into account in the proposal from the Commission, or that they were simply unable to affect the proposal significantly during the decision-making process. First, the member-states did express diversified positions in response to the 2000 Green Paper. As noted in Chapter 4, initial responses indicated that nine member-states were positive to a European emissions trading system. This meant 47 votes for emissions trading – far from the 62 needed to create a qualified majority.

179 *International Environment Reporter* (10 March 2004), ‘Russia Insists It Will Only Ratify Kyoto Pact with Expanded Market for Emission Credits’, 27:5, 177.

180 Council (31 March 2004), Working Document 7931/04 regarding: Proposal for a Directive of the European Parliament and of the Council Amending the Directive Establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community, in Respect of the Kyoto Protocol’s Project Mechanisms (Brussels: Council of the European Union, General Secretariat).

181 *Point Carbon* (20 April 2004), ‘Euro Parliament Adopts Linking Directive’.

182 *ENDS Daily* (24 May 2004), ‘Russia “Will Ratify the Kyoto Protocol”’.

Against this backdrop, the Commission organized a new consultation meeting with the member-states in autumn 2001. This meeting revealed a significant change in positions, towards broad support for an EU ETS based on a common method for allocation, common sectors and activities, adequate compliance and enforcement. Allocation of allowances should, however, be done by the member-states within the constraints of the Burden-sharing Agreement. What caused this change? A combination of factors including better knowledge and the US exit from the Kyoto Protocol were important. Particularly the US exit helped to unify the EU in support for emissions trading (see below). This means that there was a development towards convergence in the positions of the EU member-states, but they nevertheless preferred a decentralized system for allocation of allowances that would maximize their national autonomy.

Second, the Commission’s proposal was roughly in line with these positions, as were the common position and the final ET Directive. Decentralization of allocation of allowances provided the member-states with significant discretion and autonomy with regard to allocation within each country. Adding freedom with regard to verification, it has been argued that the ET Directive in reality means the establishment of 25 domestic emissions trading schemes (Lefevere 2006, 118). Key elements of the proposed ET directive thus reflected the diversity of the positions of the member-states. This helps us to understand why the proposed ET directive remained relatively unaltered throughout the decision-making process. With the Linking Directive, however, the situation was somewhat different. Here a majority of the member-states managed to change key elements of the Commission proposal related to a cap on linking, as well as the year from when linking was to take place. The linking directive proposal nevertheless adds support to the proposition based on the intergovernmental approach.

Third, the design of the EU ETS did deviate significantly from the positions of two large and important member-states, Germany and the UK, who both preferred a voluntary scheme from the outset. Such a voluntary scheme would make participation optional, thus undermining the fundamental logic of the proposed emissions trading directive. Despite the significant political and economic importance of these two states, they had to yield and support a mandatory EU ETS in the pilot phase. The concessions given to Germany and the UK in the final directive were relatively insignificant and have proved to be of little importance in practice. The main observation from this is not that the EU ETS differed from the ‘lowest common denominator’ (which is common in the EU), but rather that it differed from the interests and preferences of two of the largest and most powerful EU states. In relation to this specific issue-area, the UK and Germany are the two most important contributors to the emissions trading scheme, with together, 34 per cent of the total allowances in the first trading period. This means that the EU governments do not necessarily have control over collective decision-making even if they represent the largest EU states, both in terms of votes and related to the issue-area in question here.

The main reason why Germany and the UK had to yield was that the directive was proposed on the basis of Article 175 (1) of the EC Treaty, which provides for qualified majority voting in Council. There is, however, a norm in the Council of Ministers whereby consensus-seeking and unanimous support is always preferable.

This norm was particularly applicable in this case since the EU ETS represented a new policy instrument that affected the core of modern economies: the energy sector. And the directive was actually adopted unanimously by the 15 member-states in the Council of Ministers in 2003. Even though formal voting did not take place, the possibility of voting nevertheless put pressure to bear on the UK and Germany to make concessions.

Since a qualified majority supported the binding nature of the scheme, there was a real (although not very likely) risk that the UK and Germany could have been outvoted. It was real, since a blocking minority would require 26 votes – more than the UK and Germany combined, also if we count Finland with its three votes. Still, it was not very likely, since the UK and Germany were expected to account for a significant share of the allowance market, as later proved to be the case. In addition to qualified majority, the skill of the Danish EU Presidency in crafting the compromise, as well as internal rivalry within Germany, which weakened its negotiation position, help to explain the outcome. All in all, the EU ETS decision-making process appears to be largely, but not fully, in line with our proposition derived from the intergovernmental approach.

The next proposition stated that the EU ETS reflects the harmonization ambition of the EU institutions, rather than the positions of the member-states. This proposition got only limited support. Both the European Commission (at least initially) and the European Parliament preferred a more centralized system, particularly with regard to the allocation of allowances. The EU ETS ended up as a basically decentralized system in this respect. Finally, the EU ETS deviated significantly from the position of the EP, but to a lesser degree from that of the Commission. However, both the European Commission and the Parliament influenced the EU ETS by providing independent input to the decision-making process, thus qualifying as organizational actors.

The influence of the Commission was evident in that it was able to counterbalance many changes made to the proposed directive – on the basis of its formal powers according to the co-decision procedure, combined with several requirements and the right of approval in the subsequent implementation phase. For example, the Commission has a right to approve National Allocation Plans, as well as opt-in and opt-out provisions, and reject them if they do not comply with the requirements set out in the directive. The Commission was also very active behind the scenes in Council negotiations. This active role was facilitated by the asymmetrical distribution of knowledge between the Commission and most member-states: the Commission had more than a two-year lead in building up expertise on emissions trading. The European Parliament had the power to veto the proposed ET directive, but its actual influence on the directive was only moderate, compared its own ambitions. The Parliament aimed at making significant changes to the decentralized nature of the scheme, its coverage and method of allocation through two ‘readings’. Most the amendments aimed at strengthening the environmental integrity of the system. The final result included some modifications in that direction (see Table 5.4). For example, the EP proposed a mandatory cap on the allocation within each member-state, to ensure that allocations were sufficiently ambitious to lead to significant reductions in emissions. The Parliament did not manage to get a mandatory cap, but

ended up with a more flexible requirement: the total amount of allowances was to be consistent with a path towards the Kyoto targets.

We have discussed various reasons for the limited impact of the EP. For one thing, on many issues the Parliament found itself confronted with a powerful alliance between the Commission and a majority of the member-states and industry. Second, the time factor became important. In the final negotiations, the Parliament was very reluctant to end up as the one who delayed the start-up of the scheme. If the scheme had gone into conciliation between the Council and Parliament, the Kyoto Protocol deadline of showing demonstrable progress ‘by 2005’ would probably be out of reach. Third, it seems that the Parliament proposed too many amendments (some 80 in the first reading). If the Parliament had focused on a more limited set of amendments, its impact might have been more significant.

Non-state actors influenced the design of the EU ETS only to a very limited extent – hardly a surprising observation when decision-making is based on qualified majority. Qualified majority voting makes it difficult for industry and ENGOs to affect collective outcomes, as it requires lobby activities to be coordinated across member-states. Under unanimity rules, German industry would most likely have been able to exercise its influence by blocking the adoption of the directive. German industry did exercise some influence on the final directive in the form of the new Article on ‘pooling’ in the ET Directive. However, this derogation was of limited practical importance, and so German industry had scant influence on the design of the EU ETS through the national channel.

At EU level, however, both industry and ENGOs expressed overwhelming support for the EU Emissions Trading Scheme, even though differences in opinion persisted on specific design elements. That being said, this case also provides us with examples of different types of relationships between the EU institutions and non-state actors. First, the Commission was initially able to withstand pressure from powerful industries to include ‘opt-out’ in the proposed directive. A necessary condition for this was that DG Environment could ally with the DGs for competition and the internal market. Faced with this constellation, the industry-friendly DG Enterprise had to give in. Second, neither the European Commission nor the Parliament was able to withstand the opposition expressed by the chemical industry, represented by the European industrial federation CEFIC. The chemical industry had been included in the Green Paper, but it was excluded from the proposal for the ET directive, and managed to stay outside despite the efforts of the Parliament to get it back in. In addition to its international orientation and importance to the EU economy, the chemical industry was probably left out of the ETS because its cooperation was needed in the upcoming process on the REACH directive, and because excluding the chemical industry would help to weaken German opposition to emissions trading. Moreover, the chemical industry would have complicated the system because it covers many installations. Third, ENGOs did apparently have some influence, through the Parliament’s efforts to open up for some auctioning.

According to our final proposition, the EU Emissions Trading Scheme reflects developments within international climate regime and its provision for international emissions trading. The main impact of the international climate regime on the EU ETS in the decision-making phase was caused by the US withdrawal from the Kyoto



Protocol. This led to a crisis in the regime that penetrated the internal EU decision-making process. The US exit first served to unify the positions within and among the EU actors and institutions in climate policy. This meant that it helped to unify the Commission, the positions of the EU member-states, the Parliament and non-state actors in support for the EU ETS.

Convergence in positions among key stakeholders was also stimulated by the heightened likelihood that the Kyoto Protocol would enter into force, following the Bonn and Marrakech agreements in the summer and autumn of 2001. The EU ETS came into the spotlight as the instrument that would give the EU credibility in saving the Kyoto Protocol. The Linking Directive became increasingly important as uncertainty about Russian ratification of the Kyoto Protocol persisted much longer than expected. These effects were mutually reinforcing – the EU ETS represented the main instrument for implementing and increasingly for saving the Kyoto Protocol. If the US exit from the Kyoto Protocol had led to a collapse in the climate regime (as foreseen by the Bush Administration), perhaps the EU ETS would not have been adopted – at least not at the same time and in the same form as it did.

The Kyoto Protocol continued to affect the speed of the EU ETS decision-making process, through its ‘demonstrable progress by 2005’ time limit and the 2008–12 commitment period. These time limits placed pressure on EU actors and institutions, particularly the European Parliament, to avoid conciliation. All in all, the Kyoto Protocol and developments within the climate regime emerge as probably the most important factor in explaining why the EU ETS was adopted at all.

Even though the EU was convinced that the Kyoto Protocol would enter into force, the international climate regime had limited impact on the specific design of the EU ETS, mainly because the rules for international emissions trading were developed later and they were more general. The EU ETS was significantly more complex, as it focused on industrial action, not governmental action.

Despite their varying explanatory power, all the three explanatory perspectives offered here prove to have something to contribute, even related to the same design feature. For example, the intergovernmental member-state perspective helps us to understand why the ETS is based on decentralized allocation of allowances. The EU institutional perspective helps us to understand why the allocation of allowances must be approved by the Commission and must follow certain guidelines, including being on a path toward achieving the Kyoto targets. The international regime perspective helps us to understand why the EU ETS suddenly gained significantly more support in 2001, why the ET Directive did not go into conciliation between the Council and the Parliament – and why it was adopted at all.

## Chapter 6

# Implementing EU Emissions Trading

In this chapter, we look into the similarities and differences in implementation that were found in Chapter 3. In Chapter 2, we formulated various propositions on implementation based on our three explanatory perspectives. The first explanatory perspective views implementation from the level of the member-states, focusing on how domestic factors can explain variance in implementation. The first proposition thus took as its point of departure a decentralized EU ETS, and stated that it would lead to low but varying levels of environmental ambitiousness, due to national circumstances. A decentralized ETS would mean that each member-state was in charge of the cap-setting process, easily implying a ‘race to the bottom’.

The second explanatory perspective views implementation from the EU level, with a centralized and harmonized EU ETS as its point of departure. It suggested that a centralized EU ETS would lead to generally high(er) environmental ambitiousness due to common EU criteria. This would provide the Commission and the ECJ with significant powers to oversee the implementation process and hence induce ambitious allocations.

The final perspective views implementation from the international level. Here it is proposed that a strong link between the EU ETS and the climate regime’s flexible mechanisms, as well as low exposure to international competition, would increase environmental ambitiousness. This because the availability of relatively low-price CDM credits would make it easier for industries to agree to ambitious allocations (although also decreasing the pressure on EU governments to take real action in their own countries). Furthermore, low exposure to international competition would reduce industrial opposition to ambitious allocations.

### Member-states: Varying Implementation

As the EU ETS turned out to be basically decentralized, we expected low but varying degrees of implementation. Our assessment in Chapter 3 was largely in line with this expectation. We put forward a generally sobering assessment of implementation and ambition levels so far. It is also clear that the implementation process has been marked by significant delays in the delivery of NAPs. However, within this overall picture of only moderate success, there were striking differences in implementation. We singled out a group of four key EU countries and emitters, representing variation in implementation and geographical location: frontrunner UK, reluctant Germany, improving-laggard Spain and laggard Poland.

Significant variation in domestic implementation points towards different national circumstances and domestic-level explanations. Here we focus on ‘fit’,

'need' and 'deed' to explain variance in implementation. Institutional fit emphasizes the critical role of the pre-existing institutional context in which new policy instruments (like emissions trading) are introduced. Institutional change rarely takes place in a smooth and unproblematic way, due to existing institutions. According to Knill and Lenschow (2000, 30), 'effective implementation is basically dependent on the degree of institutional fit between existing institutional arrangements and the institutional implications emerging from European policies. Implementation is likely to be ineffective if the institutional implications of EU policies contradict strongly entrenched patterns of already existing institutions'.

We distinguish between general institutional fit and policy fit. In this study, general fit concerns the match between the portfolio of domestic climate policy instruments and emissions trading. In a broader sense, it also includes general national regulatory styles. Specific policy fit concerns the match between specific policy instruments (like domestic emissions trading) and the EU ETS. We are interested in both these dimensions and will seek to bring out the specific type of fit or misfit in each of the four national cases studied.

The second explanatory factor in focus is 'need' for the EU ETS. As noted in Chapter 1, all EU countries have varying targets agreed to within the EU's Burden-sharing Agreement (BSA), and progress so far in relation to these targets varies. In order to measure need, we will sum up the country's target within the BSA, progress made in relation to this target so far and main prospects ahead, and on this basis assess the real *need* to implement the ETS ambitiously.

Finally, we distinguish needs from deeds. The need to do something and the political willingness to do so may well be two different things. We will thus assess progress in climate policy and the basic 'drive' in each of the four countries in focus, and hence the apparent and probable willingness to match needs with climate policy deeds. Climate policy 'drive' is measured in terms of domestic targets and policy instruments. We expect that high institutional fit, need for the EU ETS, and climate policy 'drive' will lead to a frontrunner position, and, conversely, that low fit, need and drive will lead to a laggard position.

#### *The UK: Frontrunner*

As concluded in Chapter 3, when NAP I and II are viewed in combination, the UK stands out as the main forerunner in EU ETS implementation. It has managed to meet the deadlines quite well and was among the comparatively more ambitious in NAP I, even though it fought a drawn-out battle with the Commission over its wish to increase its cap a little bit (as further discussed later). In NAP II, the UK's plan was the only one to be unconditionally accepted in the first Commission NAP II 'verdict'. When the verified 2005 emissions figures were put on the table in May 2006, it became clear that the UK was one of the few countries on the short side – that is, with higher emissions than allowances distributed. On the one hand, this means that the UK certainly did not 'over-allocate', and that must be counted on the positive side. On the other hand, higher emissions go in the wrong direction for a system aiming for reductions.

However, the interpretation of such figures depends upon the background for the higher emissions. As noted in Chapter 3, one reason that has been indicated for the UK's 'short' position in 2005 is a shift to greater use of coal for power generation as gas prices have risen while coal prices have been static or falling. Not least because the UK's NAP II was the only one to gain unconditional acceptance in the first Commission NAP II assessment round, the EU Commission seemingly supports a 'basically sound approach' interpretation of recent events.

Let us then see to what extent our three explanatory perspectives can shed light upon this comparatively high implementation performance.

*Fit between UK ETS and EU ETS* In the EU ETS initiation process, the UK was a clear proponent of trading. It was apparently the only EU country positive to emissions trading during the Kyoto negotiations, and was the second EU country (after Denmark) to implement a domestic ETS. Britain's domestic emissions trading scheme created a certain institutional learning base with regard to the operation of trading, within both government and industry. This included basic data collection, the establishment and operation of allowance registries, recognition of the pros and cons of allocation methods, and, of course, a certain trading experience for industry. In 2004, both the National Audit Office (NAO) and the *ENDS Report* agreed that the creation of the allowance registry was an important 'but often over-looked' institutional success.<sup>1</sup> Moreover, a clear majority of participants in the UK ETS emphasized how participation in the system had improved their collection of data on energy use and measurement of emissions (NAO 2004, 27). The general institutional fit between British climate policy and the EU ETS was thus high.

In Chapter 5, we saw that the UK ended up as one of the main opponents to a mandatory ETS. The reason was that the design of the UK's initial domestic trading scheme, which started in March 2002, differed substantially from that of the EU ETS, and this created tension between the EU and UK. Britain's domestic system covered all six main greenhouse gases (EU: only CO<sub>2</sub>); it excluded electricity and heat generators, but included several sectors not covered by the EU ETS. The scheme was voluntary (EU: mandatory), and the British government provided funding support of 43 million pounds per year over a five-year period to encourage participation (EU: none).<sup>2</sup> The industrial target groups were instrumental in designing the scheme – indicating that the UK domestic scheme was more in accordance with their strategies than the EU ETS. Indeed, some of the patterns of interests created by

<sup>1</sup> NAO 2004; *ENDS Report* (April 2004), 'Watchdog Fails to Bite on UK Emissions Trading Scheme', Issue 351, 27–30.

<sup>2</sup> In the UK ETS, 31 organizations ('direct participants') took on targets to reduce their emissions against 1998–2000 levels, aiming to deliver close to 12 million tonnes of additional CO<sub>2</sub> equivalent emission reductions over the period 2002–06. The scheme was also open to the 6,000 companies with Climate Change Agreements, the latter setting energy-related targets. Companies that met their targets would receive an 80 per cent discount from the Climate Change Levy, a tax on the business use of energy. These companies could use the scheme either to buy allowances to meet their targets, or to sell any over-achievement. UK Department for Environment, Food and Rural Affairs [website], <[www.defra.gov.uk/environment/climatechange/trading/](http://www.defra.gov.uk/environment/climatechange/trading/)>, accessed 18 June 2007.

the scheme were clearly in conflict with the EU ETS. Moreover, due to differences in coverage, the two schemes engaged and distributed regulatory burdens among emitters differently (see also Sorrell 2003a and 2003b).

Nevertheless, the UK trading experiences facilitated the country's NAP I implementation in terms of timeliness. This was also confirmed in our interviews with British NAP decision-makers.<sup>3</sup> It was probably also a factor positive for ambitiousness, as the previous work provided some necessary data and modelling tools. In sum, although the general institutional fit was good, the specific policy fit was more 'medium', due to design differences between Britain's ETS and the emerging EU ETS.

*Reduction needs and climate policy drive* The UK has one of the most ambitious targets within the EU BSA. The UK's target is to reduce GHG emissions by 12.5 per cent by 2008–12. An even more ambitious domestic target of a 20 per cent reduction in CO<sub>2</sub> emissions by the year 2010 had been adopted back in 1997. In 1998, UK CO<sub>2</sub> emissions were already 8.5 per cent below 1990 levels. According to the European Environmental Agency (EEA) 2004 progress report, emission trends until 2002, and projections for 2010 on the basis of existing domestic policies and measures, the UK appeared on track in terms of meeting its BSA target. With regard to the more specific linear target-path towards the BSA 2010 target, in 2006 the UK was 7 percentage points below (ibid., 14).<sup>4</sup> The UK was the only EU country besides Sweden to project that existing domestic policies and measures would alone be sufficient to meet and even exceed its BSA target. This picture remained basically unchanged in the 2006 EEA report, with the UK 5.8 percentage points below the linear path (EEA 2006, 20). This indicates that the actual need for the UK to implement the ETS ambitiously was not pressing.

As to the more structural factors underlying these figures, energy liberalization and the 'dash-to-gas' can shed light on Britain's decreasing emissions in the 1990s (Collier 1997; Wettestad and Hals Butenschøn 2000). But also other factors and policies have come to complement and enhance the 'dash-to-gas' effects. As shown by Darkin (2006), the British Labour Party has actively promoted climate policy since coming to power in 1997, including the adoption of a comprehensive Climate Change Programme in 2000. And policies and measures in the industrial sector have been delivering real reductions in emissions. On the other hand – and as in most countries – the transport and households sectors are lagging behind. Furthermore, although energy efficiency has improved in the UK, rising energy demand has more than outweighed the efficiency gains (ibid., 266), and this development may also shed some light on the power sector's overshooting of its ET allowances in 2005.

We can draw two, somewhat differing, conclusions. On the one hand, good progress indicates that there has simply not been such a real need for the British government to implement the ETS *very* ambitiously, so this element does not shed much light on why the UK was the comparative leader. On the other hand, good

<sup>3</sup> UK interviews, 16 February 2005.

<sup>4</sup> The only other countries with 'scores' below the linear target path were Germany, Sweden, France, Luxembourg and Belgium (EEA 2004, 14).

progress was at least partly a result of an active climate policy. Policy drive emerges as a more important explanatory factor than the need to implement the EU ETS for understanding the UK frontrunner position.

#### *Germany: Reluctant*

Germany is of key ET importance and interest as the biggest EU emitter, accounting for almost 25 per cent of total ET allowances. Moreover, it was the EU country with the strongest objections to the ETS design proposed by the Commission. With regard to implementation, Germany must be placed somewhere in the middle, as a sort of key Northern intermediate. It has generally been on time, and ranks somewhere in the middle with regard to comparative NAP I ambitiousness. Germany ended up with slightly lower emissions in 2005 than allocated cap (around 4.2 per cent) and hence as a potential slight 'over-allocator' in NAP I. Furthermore, its proposed NAP II cap was rejected and considerably adjusted down by the Commission. As further discussed later, in NAP I, it had a long quarrel with the Commission over its suggested 'ex post' adjustment rules, and there was talk about a new fight with the Commission over its scaled-down cap in NAP II. However, Germany chose to back down, but accompanied this with a planned increased use of CDM. On the whole, it should be seen as a reluctant and cautious ETS player.

*Voluntary agreements and the EU ETS* Compared to the UK, Germany seems to be a clear case of both more general institutional misfit and more specific policy misfit in terms of emissions trading. As noted in Chapters 4 and 5, in the negotiations leading up to the Kyoto Protocol, Germany was one of the leading sceptics within the EU to flexible mechanisms, and it argued for a voluntary EU system until the end of 2002.

The most intensive German lobbying towards the EU involved a proposal for allowing companies to form collective 'pools'. This pooling proposal reflected the fact that the main instrument in German climate policy has been voluntary agreements (VAs) with industry.<sup>5</sup> The targets in the agreements have referred entirely to associations, not individual companies or sites. Agreements on CO<sub>2</sub> reductions were adopted in 1995, 1996, 2000 and 2002. As pointed out in a report from Fraunhofer-ISI (Walz and Betz 2003), the pre-2000 agreements were unilateral commitments on the part of industry, adding up to an overall target of cutting CO<sub>2</sub> emissions by up to 20 per cent by 2005 compared to 1987 levels.

Since 2000, negotiated agreements have been established on a sectoral basis. The agreements covered the companies associated in the Bundesverband Deutscher Industrie (BDI), which is the head organization of the German manufacturing industry, electricity producers, as well as coal, gas and oil suppliers. About 80 per cent of final energy consumption in industry, and almost all electricity supply (industrial and utilities, private and public producers) were covered by the agreements. These applied to 18 associations/sectors, including chemicals, non-ferrous metal industry,

<sup>5</sup> Other important German climate policy instruments have been the ecological tax reform and the Renewables Energy Sources Act. See Walz and Betz (2003).

steel, oil refining, gas and water utilities, and electricity suppliers. The overall 2012 target was a 35 per cent greenhouse gas cut (*ibid.*, 13).<sup>6</sup>

However, the substance of the commitments was diffuse, and reporting of emissions under the agreements was voluntary.<sup>7</sup> Within the German government, the Ministry of Economy was responsible for the agreements. The dominant role of these agreements in German climate policy indicated a potential misfit in relation to the emerging EU ETS. With the voluntary agreements, the balance of power between industry and government was tilted in favour of industry, which controlled the reporting of data. These data were primarily at the aggregate, sectoral level; targets were open to interpretation; and no sanctioning mechanism was involved.<sup>8</sup>

All this stands in contrast to the EU ETS, which is a mandatory system with an elaborate data collection and monitoring system reaching down to the individual corporation level, and with a clear and explicit sanctioning and non-compliance mechanism. Most German industry was generally quite satisfied with the regulatory regime based on VAs, and embraced emissions trading only very reluctantly and hesitantly. In September 2005 it was reported that more than two-thirds of German installations still had a negative attitude to emissions trading.<sup>9</sup> In essence, German industry anticipated higher abatement costs under the EU ETS than with the voluntary agreements.

The picture is not entirely bleak, however. Closer examination of the negotiations on the German NAP I cap between mid-2003 and March 2004 shows that the voluntary agreements came to represent one of four main focal points in the complicated and contentious process of determining the total emissions cap (Matthes and Schafhausen forthcoming 2007; Mullins 2005, 188).<sup>10</sup> In this specific process, the VAs functioned constructively. More generally, the skewedness in the balance of power between industry and government represented may have served as a driver within the environmental agencies for effective implementation of the EU ETS, since this instrument would provide the regulators with more power vis-à-vis the regulated.

Compared to the case of the UK, both a general and a specific misfit seem to explain why Germany has lagged somewhat behind.

<sup>6</sup> This target was mainly a relative one, set in relation to a production index. See Walz and Betz (2003, 139).

<sup>7</sup> Interviews, Berlin 28–29 September 2005.

<sup>8</sup> According to Matthes and Schafhausen (2005, 38), this means that Germany's NAP process has been complicated by 'a poor data situation and very incomplete information'.

<sup>9</sup> *Point Carbon* (22 February 22, 2005), 'Polish NAP Under Pressure'.

<sup>10</sup> The VA focal point was favoured by the German Ministry of the Environment (BMU). The other three focal points were a 'proportional' approach, a 'non-ET stabilization' approach and a 'cost-efficiency' approach. See Matthes and Schafhausen (2005, 12–13). Interviews in Berlin, 28–29 September 2005.

*Climate policy progress: good, but slowing down?* Compared again to the UK, we would also expect that either the need for ambitious allocation was lower in Germany than in the UK, or that the German policy drive was less vigorous – or both.

Germany has traditionally been a leader in climate policy within the EU and would probably like to uphold this position, also in the age of emissions trading. The German BSA target is a 21 per cent reduction by 2008–12, the second most ambitious one within the EU (together with Denmark). Somewhat similar to the UK, according to the EEA (2006), emission trends until 2004 and projections for 2010 indicate that the Germany has managed to stay basically on track to meet its BSA target by using additional domestic policies and measures. As noted in Chapter 4, the development of GHG emissions in Germany is related to the fall of the Berlin Wall and subsequent re-unification effects. The rate of emissions decrease was highest in the early 1990s. After that came a consistent, but slower, decline in emissions throughout the 1990s, and emissions became quite constant after 1999 (Walz and Betz 2003, 2; Matthes and Schafhausen 2005, 1). As to the more specific linear path towards the BSA 2010 target, in 2004 Germany was 2.8 percentage points below (*ibid.*, 20).

On the one hand, there seems to be no pressing need for drastic measures. This is quite similar to the situation in the UK and can hence shed little light on the comparatively lower ambitiousness of Germany. On the other hand, we should note that progress was less encouraging in 2006 than it was in 2004, although an increase in emissions may be caused various different factors.<sup>11</sup> This immediate impression of a decreasing climate policy drive in the recent years is strengthened by recent statements by German officials. In April 2007, Germany's environment minister Sigmar Gabriel stated that it was 'disappointing that Germany had fallen away from that [the 21 per cent] target in recent years', adding that 'Germany, and other countries, issued more certificates than necessary'.<sup>12</sup> This may indicate that in recent years the basic climate policy drive may have been less strong in Germany than in the UK. Hence, Germany's willingness to implement the ETS ambitiously may have been comparatively lower.

#### *Spain: an Improving Laggard*

As concluded in Chapter 3, Spain occupies a sort of intermediate position in terms of ETS performance so far. Spain was initially very delayed in NAP I, but speeded up significantly from late spring 2005 on and ended up with a comparatively acceptable NAP. When 2005 emissions were put on the table, Spain proved to be among the few countries that had not handed out more allowances than the ETS industries needed and hence was on the 'under-allocation' side, further supporting the impression of a certain NAP I soberness. Spain's NAP II has been favourably received and

<sup>11</sup> Here it should be noted that in the 2004 EEA assessment Germany was 6 percentage points below the linear target path (EEA 2004, 14).

<sup>12</sup> Reuters/Planetark (19 April 2007), 'German Cabinet Accepts EU's CO<sub>2</sub> Allocation Plan'.



– as was the case with only a few countries – its cap was basically accepted by the Commission at the first attempt.

*Lack of climate policy rather than misfit* Economic instruments have not figured centrally in Spanish environmental policy, so general institutional fit must be characterized as being on the low side.<sup>13</sup> With regard to more specific policy fit, the case seems to be more a lack of previous policy and general policy foundation than a specific mismatch. In 2003, Tabara (2003, 20) noted: ‘for a long time, Spanish politics have framed climate change either as a non-issue or as a burden for economic growth and competitiveness, and as a result still suffers from such passivity and inertia which are now very difficult to overcome’. Spain has not had an overarching climate change strategy. Domestic policies to mitigate climate change have focused on the introduction of combined-cycle gas turbine plants to cover additional energy demand, a reduction of energy intensity, and an increase in renewable energy policies (International Energy Agency 2005). In an environmental performance review from 2004, the OECD pointed out that climate change has not been among the top environmental issues in Spain; priority has traditionally gone to water quality. This can help to explain why Spain seems to have accorded low priority to the negotiations on the ETS directive from 2001 to 2003.<sup>14</sup>

Thus, in the case of Spain, not only has general fit been low, a specific policy foundation for the ETS has also been lacking.

*Needs and climate policy progress: from inertia to action* In 2004, with the EU’s NAP I deadline getting closer, a public debate developed in Spain, questioning the fairness of the country’s target under the BSA.<sup>15</sup> Under that agreement, Spain, like several other southern EU states, is allowed to increase its greenhouse gas emissions, but Spain’s target of a 15 per cent emissions increase has been characterized as somewhat stricter than other southern targets and national policy at the time (Ringius 1999).

By 2000, Spanish emissions had risen far more than the target (29 per cent above 1990 level); by 2004, emissions were almost 45 per cent higher than 1990 levels. Furthermore, as pointed out in the 2004 EEA assessment, Spain was 30 percentage points above a linear Kyoto target path (EEA 2004, 14). According to the 2006 EEA assessment, the situation has remained basically the same (EEA 2006, 20). No wonder then that Spain has been included in a group of seven countries singled out by the European Commission as being at risk of not meeting their BSA targets.<sup>16</sup> In sum, we must conclude that there has been a considerable need to squeeze also the industries covered by the EU ETS. However, for quite a long period, Madrid failed

<sup>13</sup> For instance, the OECD recommended to increasing the use of economic instruments in its 2004 Environmental Performance Review (OECD 2004, 17).

<sup>14</sup> Interviews in Madrid, 9–10 May 2005.

<sup>15</sup> *ENDS Daily* (28 January 2004), ‘Spain Wobbles on Kyoto Protocol Commitments’, Issue 1597.

<sup>16</sup> The six others are Austria, Belgium, Denmark, Ireland, Italy and Portugal. *ENDS Report* (December 2006), ‘Prospects for EU Emissions Worsen’, 3.

to act on this need. This was much rooted in fundamental scepticism to climate politics and the Kyoto Protocol within Spain’s ruling conservative government.<sup>17</sup>

It was only with the new socialist government in April 2004 that the Spanish implementation process started to follow a completely different track. The new Prime Minister early on pledged to comply with the ET Directive whatever the cost, and was followed by the new Minister of the Environment harshly criticizing the outgoing government for not following up on the Kyoto commitments. A contribution to relaxing the opposition towards emissions trading in the business community came with the appointment of a former representative of industry (from the company Repsol) to Director of the Spanish Climate Office.<sup>18</sup> This new speed and political pressure in the implementation process resulted in a draft Spanish NAP I being published at the end of June 2004, considerably earlier than expected.<sup>19</sup> And, as noted, the new drive in Spanish climate policy led to a NAP II that was applauded and approved by the Commission at first try in late February 2007. From the Spanish case we see how a change in climate policy drive came about due to a change in government, which in turn responded to the accumulated pressing need for action.

#### *Poland: Struggling*

It is hard to escape the conclusion that Poland must be counted as figuring centrally among the ETS implementation laggards so far. Poland is the third largest emitter in the EU and accounts for around 11 per cent of the allowances. Hence, its timeliness and performance is important for the developing market. It was seriously delayed in NAP I, and its cap indicated comparatively little ambition. When 2005 figures were put on the table, Poland proved to be among countries that had been most generous in handing out allowances to the ET industry (emerging as a clear ‘over-allocator’). Although the country was on time in NAP II, its ambitiousness has again been seriously questioned. This was confirmed in late March 2007, when the Commission cut Poland’s suggested NAP II by as much as 27 per cent (down from 284.6 million allowances to 208.5).

*Lack of institutional fit* A look at the history of environmental regulation in the Central and East European Countries (CEECs) shows that, prior to 1990, the overall regulatory style focused on national quality standards and pollution permits. In the 1990s, however, virtually all new environmental policy principles were imported from the West, and the CEECs have shown a general preference for new policy instruments like market-based instruments and self-regulation (Jehlicka and Tickle 2002, 2004). However, as we have discussed in greater detail elsewhere (Skjærseth and Wettstad 2007), the general institutional *capacity* for effective environmental policy development and implementation in the CEECs has been characterized as weak. Ministries of the environment and their departments

<sup>17</sup> Interviews in Madrid, 9–10 May 2005.

<sup>18</sup> Interviews in Madrid, 9–10 May 2005.

<sup>19</sup> *ENDS Daily* (10 June 2004), ‘EU Urged to Take Hard Line on Emissions Plans’, Issue 1684.

of EU integration are understaffed and without appropriately trained experts. Environmental ministries often perform merely a coordinating and consultative role and lack the administrative capacity to implement and enforce environmental regulation (Homeyer 2001; Kramer 2002). Thus, in terms of general institutional fit, including the capacity to implement so complex an instrument as the EU ETS, the picture was not encouraging.

Poland has been described as a country with mixed attitudes towards emissions trading (Fernandez Armenteros and Massai 2005, 440–442). However, climate change did not constitute a major priority with the Ministry of the Environment, and there has been resistance from politicians and decision-makers ‘which still prefer other instruments already established and which present faster and more visible positive results on the national environment than a new system where there is not yet sufficient experience’ (ibid., 441). Polish climate policy consists of various national policy plans emphasizing various measures, including renewable energy. Several new legal acts with relevance for climate policy have been adopted since 1997. For example, the 1997 Energy Act aims to stimulate the use of renewable energy sources. However, according to *Warsaw Press*, ‘the government is coming to the issue too late, with no time, no funding, and almost no data’.<sup>20</sup>

In sum, in addition to weak administrative capacity, the general fit between emissions trading and Polish climate policy must be characterized as low. So what about the actual need for effective implementation stemming from Kyoto commitments?

*Climate policy progress: comfortably numbing?* As with other CEECs, Poland is a party both to the UNFCCC and to the Kyoto Protocol, with status as ‘Economies in Transition’ (EITs). They are not part of the EU’s Burden-sharing Agreement, which applies only to the ‘old’ EU-15.

From late 2002 on and with formal accession approaching, the CEECs were granted more access to EU decision-making, including climate policy, through the establishment of the ‘Interim Committee’.<sup>21</sup> The process of gradually closer involvement was further strengthened by the important European Council meeting in April 2003 and the signing of the Accession Treaties. The CEECs were included as observers in the final stages of negotiations on the EU ET Directive, including both the second reading in the European Parliament and the final deliberations in the Council.<sup>22</sup> The CEECs took a more active part in the negotiations on the Linking Directive all along.

<sup>20</sup> *Warsaw Press* (1 March 2004).

<sup>21</sup> This Committee, established to allow the CEECs to comment on EU draft legislation concerning the signature of the Accession Treaties, was composed of representatives of the EU, the EU Commission, the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. See Fernandez Armenteros and Massai (2005, 432).

<sup>22</sup> For instance, Dr Tibor Farago, Director-General of the Hungarian Ministry of the Environment, stated: ‘we have followed the negotiations on the [ETS] Directive very closely, and have also expressed our concern on the linking proposal...At the moment we are waiting for the Commission’s guidelines on the NAP’. *Point Carbon* (22 August 2003), ‘Hungary: Late Bloomer by Intent’, *Point Carbon Carbon Market Europe*, 1.

All CEECs have ratified the Kyoto Protocol, which commits them to emissions limitations as Annex B Parties. Poland has a 6 per cent reduction target. However, given the economic and industrial restructuring processes underway in the CEECs in the post-Communist 1990s, their Kyoto targets are generally expected to be quite generous. Moreover, this development has been expected to set them up as sellers of allowances in the ETS.

As expected, progress in 2002 was fairly good. The 2004 EEA assessment noted that Poland was 29 percentage points below a linear Kyoto target path (EEA 2004, 17). According to the 2006 EEA assessment, recent progress has been only marginally less promising (two percentage points ‘down’) (EEA 2006, 23). According to *Point Carbon*, this development led representatives of the Polish Ministry of the Environment to state in February 2005 that Poland had already met its Kyoto commitments and that was why ‘it doesn’t really have to take part in EU ETS’.<sup>23</sup> Furthermore, since many other Kyoto signatories seemed set to overshoot their targets, the progress made in Poland led many to expect a reward when allowances were allocated. A windfall for industry was foreseen in allowance sales.<sup>24</sup>

However, the 2006 EEA report also contained a warning signal, as by 2010, CEEC greenhouse gas emissions are expected to increase by 11 percentage points (EEA 2006, 24). This warning signal has clearly been picked up by industry. For instance, in spring 2005, when the Commission demanded a significant cut of the proposed Polish cap, this created an uproar in several sectors of Polish industry – including cement, steel and power. Such a cut ‘could hinder the growth of the Polish economy’.<sup>25</sup> This concern on the part of trade union and industry about the need for future allowances related to a fast-growing economy was shared by the Polish government, which in March 2005 stated that it was careful not to create ‘artificial barriers to further economic growth’.<sup>26</sup> The case of Poland was further complicated by a change of government and environment minister in spring 2005. This led to further delays in the Polish ETS implementation process, and the late entry of Polish companies impeded market maturity.

In sum, there was little need for Poland to implement the ETS ambitiously, and economic growth prospects meant also low willingness to do so.

### *Comparative Patterns*

Table 6.1 shows that expectations have been roughly in line with actual implementation patterns. This indicates that our three explanatory factors have been able to explain differences in implementation reasonably well.

<sup>23</sup> *Point Carbon* (22 February 2005), ‘Polish NAP Under Pressure’.

<sup>24</sup> *EU Energy* (22 April 2005), ‘Little Hope for CO<sub>2</sub> Allowance Deal between Poland, EC’, Issue 106, 14–15.

<sup>25</sup> *EU Energy* (25 March 2005), ‘Government, Industry “Disappointed” by EU NAP Decision’, Issue 104, 18.

<sup>26</sup> Reuters/Planetark (10 March 2005), ‘Poland Weighing Legal Options on EU Emissions’.

**Table 6.1** Implementation of the EU ETS: Expected vs. actual outcome (in relative terms)

	Fit	Need	Deed/drive	Expected outcome	Actual outcome
UK	M/H	L/M	H	Intermediate/ Frontrunner	Frontrunner
Germany	L/M	L/M	H/M	Intermediate	Intermediate
Spain	L	H	L/M (C)	Laggard/ Intermediate	Laggard/ Intermediate (C)
Poland	L	L	L	Laggard	Laggard

C=Change

Together with Germany, the UK was the EU country that expressed the most vehement opposition to the Commission's suggested ETS design. This was clearly related to domestic climate policy design and a wish to improve the more specific policy fit between domestic and EU design. In contrast to Germany, emissions trading figured prominently in the British policy mix, so there was more of a slight policy misfit than a more general and serious institutional misfit. The underlying attitude towards emissions trading was basically positive and valuable lessons were being learnt. These domestic experiences also helped in the process of modelling and producing emission caps, applauded in both NAP I and II. However, this must primarily be seen as the result of good bureaucratic footwork, within a political context where some actual weight was given to climate policy. There was governmental willingness to squeeze industry (particularly the power sector), but overall good climate policy progress meant that there was no real need to squeeze the industry covered by the EU ETS *very* hard.

Germany was in many ways the main opponent to the European Commission in the development of the EU ETS. Hence Germany's rather quarrelsome performance in the implementation process can stand as a prime illustration of the importance of seeing decision-making and implementation in combination. It is also clear that problematic institutional fit due to reliance on voluntary agreements can help to explain both Germany's opposition in the decision-making phase and its reluctant implementation performance. On the other hand, a closer look reveals that the voluntary agreements have not *only* complicated things: they also provided helpful focal points in the messy first allocation round.

Although Germany's comparatively ambitious burden-sharing target leaves no room for complacency, adequate climate policy progress has meant that the actual need to squeeze German industry covered by the ETS *very* hard has simply not been present, thus far. However, there are signs that Germany's climate policy drive has been getting weaker in recent years. Furthermore, scattered evidence about the generally critical and hesitant role of industry, which relinquished the voluntary agreements with regret, further supports our placing Germany, at best, in the intermediate category with regard to ETS performance to date.

Spain is interesting because it displays change in implementation over time. The need for an ambitious EU ETS performance was extremely high for Spain to reach its goal according to the BSA. But it took a new government in spring of 2004 to act upon this need. Hence, a combination of high need and change in climate policy drive is the key to understanding the case of Spain.

In the case of Poland, institutional and policy fit was low. In addition, post-Communism restructuring effects, in terms of markedly reduced emissions, meant that the country did not have any need for the EU ETS. Finally, the country's economic growth prospects meant little interest in an active climate policy.

### The EU Dimension

Although the EU ETS became basically decentralized, the allocation of allowances was not unconstrained. As noted in Chapter 3, Annex III of the ET Directive contained several optional and mandatory criteria that member-states had to respect. One of the most important criteria was the need to be on a path towards the Kyoto target in the period 2005–07 and consistent with Kyoto targets in the period 2008–12. This provision resulted largely from the European Parliament's efforts to centralize the system towards setting the cap on the total quantity of allowances at EU level. The European Commission has the authority to approve and consequently reject National Allocation Plans (NAPs) which, in its view, do not comply with the relevant provisions. This means that our second proposition on the consequences of a centralized system is still worth exploring, since the EU ETS included elements aimed at harmonizing NAPs. More specifically, we proposed that such elements would pull in the direction of greater environmental ambitiousness. By contrast, a decentralized system would be likely to lead to a 'race to the bottom', as each member-state would have incentives to protect its own industries by providing them with generous allocations of allowances.

To shed further light on this common moderation, we need a closer look at some shared factors, the first of these being located at the EU level.

#### A 'race to the bottom'?

Like most other EU policy-making and implementation, the EU ETS entails a dimension of economic competition between the EU states which cannot be fully grasped by examining the countries individually. An implementation process that involves both high initial uncertainty and high speed may make this competitive dimension even more pertinent, as countries will have little time to check on what others are doing. Combined with a low degree of harmonization, this will facilitate a 'race to the bottom'. After all, no state wants to end up as the one left 'holding the bag', with industry at a disadvantage compared to the competitors. The EU ETS NAP I process is a good illustration of such dynamics. As stressed by Vis (2006b, 187), relevant data were initially in short supply. Furthermore, as Vis notes, the underlying competitive challenge can be seen in the treatment of new entrants, where '... fear that [treating] new entrants any less favourably than neighbouring

Member States would mean that new investment would tend to go to Member States where allocation was for free' (ibid., 196).

The high policy-making speed and time pressure originated in Brussels and the generally tight ETS schedule set by the Commission (see, for example, Pew Center 2005, 9). The tight schedule must also be understood in light of the fact that, although there had been some previous experiences with domestic emissions trading, this instrument was quite new to all concerned. A closer look at some of the countries in focus here confirms that the tight schedule had unfortunate domestic effects. Even in the comparatively well-prepared UK, time constraints and the impossibility of consulting with other member-states were pointed out in our interviews in the winter of 2005.<sup>27</sup> As for Spain, its case is of course somewhat extreme, as the absence of almost any action in the early NAP I phase led to a high-pressure situation when the new government took over, and things suddenly started happening.

Time constraints led countries to focus 'inwards'. There was simply not enough time for consulting with other member-states and learning from them, although some valuable consultations did take place within the framework of the Climate Change Committee (see Vis 2006b, 204). No wonder then that the logic of the process resembled a 'race to the bottom', where competitiveness concerns gave member-states incentives to over-allocate permits.<sup>28</sup> As noted in Chapter 3, the strongest indication of this dynamics was the observation that, in 2005, the number of allowances distributed to installations in order to cover 2005 emissions was about 4 per cent higher than actual CO<sub>2</sub> emissions.

#### *The Commission as Watchdog*

The Commission was assigned the function as the main supervisor and watchdog in relation to the processes of drawing up the NAPs and implementing the ETS. In the spirit of a decentralized system, 'the Commission's role was always going to be one of moderate tightening, as opposed to wholesale revision' (Vis 2006b, 201). As mentioned in Chapter 3, the Commission was also responsible for producing guidelines to Annex III for the NAP I process. These guidelines were criticized for being vague and delayed. In December 2003, *Point Carbon* reported that allocation processes were slowing down, as all parties waited for the allocation guidelines from the European Commission, guidance as to the treatment of new entrants was characterized as far from clear.<sup>29</sup>

However, as pointed out by CEPS (2005), we should bear in mind that, in line with their preferences for a decentralized ETS and the assignment of moderate watchdog powers, also the member-states would rather have guidance that was not too clear or restrictive. As shown in Chapter 5, the European Parliament tried to increase harmonization and make Annex III more detailed, but failed – largely

<sup>27</sup> UK interviews, 16 February 2005.

<sup>28</sup> This has also been pointed out in other studies; see for example Bowyer et al. 2005, 18.

<sup>29</sup> *Point Carbon* (22 June 2004), 'Feature: New Entrants Reserves are the Great Unknowns'; CEPS 2005, 22.

because the member-states did not want to give too much influence to the European Commission on allocation.

So did the efforts of the European Parliament and the Commission pay off in terms of higher levels of ambition? The answer is yes, to some extent. At the outset of the NAP I process, several Commission representatives expressed explicit wishes for ambitiousness in the member-state NAPs and related scarcity in the subsequent market. For instance, the head of DG ENV, Catherine Day, stated in February 2004: 'there must be an underlying scarcity in the market' and 'the scarcity will exist at two levels: overall for the installations covered by the Directive, and individually, installation by installation'.<sup>30</sup> This call was repeated by DG ENV senior official Peter Vis in April 2004: 'the market cannot be long as a whole, there must be scarcity if it is to work'.<sup>31</sup> So, from the very outset, the Commission tried to encourage member-states to make an extra effort.

On the whole, it managed to shave off some 290 million tonnes of the proposed NAP I total, as well as securing commitments to cancel the remains of new entrants' reserves in several cases. However, this represents only 4.5 per cent of the total allocation of about 6.6 billion tonnes – not very much. In NAP I the Commission spent considerable time on the continuing and administratively burdensome quarrelling with EU heavyweights like the UK and Germany. The case of the UK has been characterized as the most protracted; it concerned the UK's attempt to revise and adjust its 2005–07 total cap 20 million tonnes upwards (from 736 to 756 million tonnes CO<sub>2</sub>) in light of revised energy and emissions projections. Although the UK took its case to the Court of Justice and got principal approval there in November 2005, the Commission refused to accept the UK's revised plan. As for the German case, it centred on the German government's wish to 'ex post' take back allowances if actual emissions should come in below expectations (indicating over-allocation). The Commission maintained that this would add unnecessary uncertainty to an already complex situation; it refused, but lost out in the end. Neither of these cases involved large quantities of allowances. However, judging by Peter Vis's account of these processes, the Commission saw these 'heavyweight cases' in a wider perspective and was worried about possible precedence effects (Vis 2006b).

As to effects in terms of percentages shaved off proposed NAPs, the role of the Commission was more important in the cases of Italy and Poland. Their proposed NAPs were rejected by the Commission, and continuing pressure led to relatively significant changes in both cases. For Italy, the final annual cap was 23 million tonnes lower than the initially proposed 255.5 million tonnes – 232.5 million tonnes and hence a 9 per cent cut.<sup>32</sup> Poland went through several rounds, finally ending up with an annual cap of 235.6 million tonnes – down 42 million tonnes or about 15 per cent from the initially proposed 277.4 million tonnes.

With NAP II, the Commission adopted a generally tougher line of action. In its first assessment round in late November 2006, the Commission proposed changes

<sup>30</sup> *Point Carbon* (2 February 2004), 'NAPs Must Leave EU Emissions Market Short'.

<sup>31</sup> *Point Carbon* (22 April 2004), 'EC Calls for Market Scarcity'.

<sup>32</sup> EU Energy (3 June 2005), 'EC Cuts Italian NAP by 9%', Issue 109, 3–4.



to nine out of ten plans, together accounting for around 42 per cent of the emissions covered by the ETS. Given Germany's position as top EU emitter, the 28 million tonnes (approx. 7 per cent) shaved off its plan was particularly important – from a suggested 482 million tonnes to the accepted 453.1 million tonnes. The 27 per cent cut of the EU's third-largest emitter, Poland, was also a significant act of increased toughness. As noted in Chapter 3, the suggested NAP II cap cuts add up to around 9 per cent, already clearly above what the Commission achieved in NAP I (see Tables 3.4 and 3.6).

With the introduction of explicit and specific formulas for deciding NAP II overall and CDM caps, it is important to note that the Commission, rather quietly and almost unnoticed, has in practice already introduced a more centralized model for setting caps in the EU ETS. What is basically left for the member-states is the installation-level allocation. The apparently quiet overall acceptance of this development is probably grounded in an increasing realization among member-states that the decentralized approach they initially favoured has not worked well enough. In addition come the May 2006 shock-waves related to the first publication of 2005 ET emissions indicating significant over-allocation.

In sum, there are EU-level factors which can shed light on common pilot phase moderation. Especially the decentralized NAP I process, spurring an initial 'race to the bottom' and the setting up of the Commission as a moderately powerful watchdog, is important in this respect. However, the harmonizing elements of the national allocation process and the utilization of its 'watchdog' role exerted by European Commission have pulled in the direction of higher levels of ambition, as expected. This development has been taken a significant step forward in NAP II. Let us then move on to other possible explanations at the international level.

### International Perspective

According to the final proposition put forth in Chapter 2, a strong link between the EU ETS and the climate regime's flexible mechanisms, and low industrial exposure to global competition, would increase the willingness of member-states to accept ambitious ETS allocation. The first part of this proposition primarily concerns the link between the NAPs and the Clean Development Mechanism (CDM). As noted in Chapter 5, the link between the EU ETS and the Kyoto mechanisms was hotly debated in the decision-making processes. A main outcome was that it became possible for EU member-states to use credits/allowances stemming from CDM projects already from 2005 on, which could potentially influence both the NAP I processes and the very functioning of the ET market. As CDM projects in developing countries entail higher risks and greater complexity than allowance trading between industrialized countries, it is generally assumed that CDM allowances/credits will be traded at lower prices than EU allowances. The availability of CDM credits would thus make it easier for industries to agree to ambitious measures, implying that a strong link between the NAPs and CDM is likely to increase ambitiousness.

The second part of the proposition has to do with the fact that the industries covered by the ETS are exposed to global competition (albeit to varying degrees);

hence it may be inadequate to look only at domestic and EU factors in order to fully understand EU industry strategies and action. In essence, the moderate level of ambition may have been caused by opposition from EU industries fearing global competitive effects.

### Industry Competition and Opposition

The EU ETS covers only certain industries and 'activities'. Basically, we may distinguish between two main categories of ET industries: power producers, and power consumers. Power production in the EU normally takes place within sub-regional European markets, so global competition is not a relevant factor in this case. The power consumers have generally been highly sceptical to a strict cap-and-trade system. The question here is whether power-consuming industries under the EU ETS are exposed to global competition which has further amplified their resistance to ambitious allocation.

In 2004, the British *Carbon Trust* organization published a study of the implications of the EU ETS for industrial competitiveness in the UK (Carbon Trust 2004). Of the five sectors studied (electricity, cement, paper, steel, and aluminium), global concerns were found to be of some relevance only for the four latter, of which aluminium is not included in the EU ETS. As for cement, although it cannot travel economically far on land, it can be transported at sea at reasonable cost. However, at least in the case of the UK, import penetration from outside the EU is very low (around 5 per cent), so only in a longer-term scenario, with considerably higher allowance prices, do global concerns really kick in. The same basically goes for paper, where imports from outside the EU are at around 15 per cent.

Steel, however, is in a somewhat different position. Industry believes that, due in part to the significant global trade in steel, it may be very difficult to pass cost increases (caused by the ETS) through to prices (ibid., 19). Especially in a more long-term scenario with considerably higher allowance prices, the *Carbon Trust* notes: 'EU producers would suffer if other major producers did not face carbon constraints' (ibid., 20).

Although the *Carbon Trust* has studied only British industry, there is little reason to believe that the situation is fundamentally different for the power-consuming industries of other EU countries. For instance, in March 2005, the president of the Polish metallurgical industry federation noted the booming demand for steel in the global market and how the EU ETS could negatively affect Polish exports to this market.<sup>33</sup> On the whole, although the issue of global competition is relevant, it is not very important in this connection. Of the industries so far covered by the EU ETS, global competition appears to be most important in the case of steel. Thus, there is little reason to ascribe the moderate ambitiousness of ETS NAP I to fears about global competitive effects. On the other hand, the factor will probably become more important in a long-term perspective, particularly if global competitors remain outside the global regulatory framework that succeeds the Kyoto Protocol.

<sup>33</sup> *EU Energy* (25 March 2005), 'Government, Industry "Disappointed" by EU NAP Decision', Issue 104, 18.

Still, resistance from industrial target groups appears to be a significant reason for the moderate level of ambition in phase I. If we look at the strategies of industries in the four countries selected for analysis in this chapter, the similarities in resistance are far more striking than the differences. In the UK, several observers have reported that industry engaged in lobbying in order to maximize their allocations under the EU ETS.<sup>34</sup> For instance, when James Cameron, CEO of 'Climate Change Capital' addressed a UK Parliamentary Committee, he stated: 'Claims on competitiveness around the UK's allocation plan – led by the CBI – have been very badly managed ... very misleading, counterproductive and irresponsible, but they have worked'.<sup>35</sup> In Germany, 'The president of the BDI ... expressed his satisfaction that new burdens on industry had been prevented' while WWF Germany stated that 'the red-green coalition had "castrated" the EU ETS by giving in to industry'.<sup>36</sup> Similarly, other sources reported about 'industry sceptical of emissions trading plan' and the situation 'complicated by the various lobby groups vying to influence the system to suit their interests'.<sup>37</sup>

In Spain, the pressure from industry changed from an effort to sabotage the whole implementation process to ensure that the ambitiousness of the allocation, the cap, was lenient.<sup>38</sup> In Poland, strong dissatisfaction was reported on the part of industry: industry did not feel it had been given sufficient credit for undergoing a painful restructuring process.<sup>39</sup> Also trade union opposition was noted, as allowances were seen as too low and it felt that they would slow production in one of the fastest growing economies in Europe.<sup>40</sup> When the Commission demanded a significant cut of the proposed Polish cap in the spring of 2005, this created a further uproar in Polish industry, not least in the cement, steel and power sectors.<sup>41</sup>

These scattered observations indicate that industry in general lobbied to maximize its allocations under the EU ETS, and this can add to our understanding of moderate ambition levels in the first round of allocation. But industrial lobbying seems to have been based on general concern about rising abatement costs, rather than fear of global competition.

34 *ENDS Report* (February 2004), 'Horsetrading Gets Under Way on Emissions Allocation Plan', Issue 349, 5; *ENDS Report* (May 2004), 'DEFRA Loses the Initiative with Delayed Emissions Allocation Plan', Issue 352, 41; Friends of the Earth (27 October 2004), 'Blair Caves in to Industry on Climate', FoE press release.

35 *ENDS Report* (January 2005), 'MPs Attack CBI "Scaremongering" on Climate Change Costs', Issue 360, 30.

36 *Euractiv* (31 March 2004), 'German Emissions Trading Compromise Hailed by Industry, Condemned by Green NGOs'.

37 *Deutsche Welle* (25 February 2004), 'German Industry and Green at Loggerheads over Emissions Plan'.

38 Interviews in Madrid, 9–10 May 2005.

39 *Point Carbon* (14 May 2004), 'Viewpoint: Polish ETS Case Undermining Kyoto Principles?', *Point Carbon, Carbon Market Europe*, 1.

40 *International Environment Reporter* (28 July 2004), 'Poland Developing Draft Plan with Business to Join European Carbon Trading Scheme', 27:15, 586.

41 *EU Energy* (25 March 2005), 'Government, Industry "Disappointed" by EU NAP Decision', Issue 104, 18.

### EU ETS and the CDM

The Linking Directive opened up for the possibility of using credits stemming from CDM projects already from the start of the EU ETS in 2005. However, the EU countries have no formal international targets to comply with before the 2008–12 Kyoto commitment period. This is why discussions about NAP I ambition-levels centred on a 'path towards' the Kyoto targets in the ETS 2005–07 pilot phase and 'consistent with' the Kyoto targets 2008–12. In reality there was little sense in 'using up' CDM credits in the pilot phase, even if they were available (which they were only to a very limited extent, as further described below).

Although interest in and priority given to the development of CDM projects surged in the wake of high ETS prices in 2005 (see Grubb and Neuhoff 2006, 19), the capacity of the CDM Executive Board to assess and approve projects has been limited.<sup>42</sup> The CDM Board has been characterized as a bottleneck in the system.<sup>43</sup> By late 2006, approximately 1400 projects had been submitted, with some 430 formally registered. Of these, the Board had approved 88 projects and actually issued 'Certified Emissions Reductions' (CERs), the latter amounting to 22 million tonnes CO<sub>2</sub>.<sup>44</sup> This is roughly similar to Slovenia's total allowances in the ETS pilot phase. Seen in light of the over-supply of allowances in the pilot phase, and the still non-operative UNFCCC International Transaction Log (the global allowance registry, meaning no formal possibility to use CDM credits so far), no companies seem inclined to use CDM credits for compliance purposes in the ETS pilot phase.<sup>45</sup> This means that the CDM factor is basically insignificant for understanding the level of ambition in NAP I.

However, for the second phase of the EU ETS, the CDM issue becomes far more pertinent. Earlier EU discussions about 'supplementarity' centred on the extent to which member-states could rely on credits from the Kyoto mechanisms. As further discussed in Chapter 5, in addition to opening up for CDM credits from 2005 on, a main outcome was a general requirement that the use of the mechanisms should be only 'supplemental to domestic action'. In the Commission's December 2005 guidelines for second-phase NAPs, no further specified limit was introduced. The Commission merely repeated that member-states' planned use of such credits should be consistent with their supplementarity obligations under the Kyoto Protocol. States were free to choose whether to apply the limit individually with respect to each installation, or collectively to all installations.<sup>46</sup>

42 The CDM Executive Board is composed of ten members drawn from all constituencies of parties to the Kyoto Protocol.

43 See, for example, Egenhofer 2005; Reuters/Planetark (9 November 2006), 'Investors Wary of Kyoto Market Controls'.

44 *Point Carbon* (13 December 2006), 'CDM and JI Project Pipeline', *CDM & JI Monitor*, 3.

45 *EU Energy* (6 April 2007), 'Delays in Registry-ITL Links Threaten Emissions Trading from 2008', Issue 155, 10.

46 European Commission (22 December 2005), COM(2005)703 Final, Communication from the Commission: Further Guidance on Allocation Plans for the 2008 to 2012 Trading Period of the EU Emissions Trading Scheme (Brussels), 7–8.

The Commission's first NAP II verdict in late November 2006 provided further clarification on supplementarity. The press release was explicit: 'the Commission considers that, as a general rule, installations should be allowed to use JI and CDM credits to supplement their allowance allocation by up to 10 per cent. In assessing proposed limits that are greater than 10 per cent, the Commission has taken into account the efforts a member-state has to undertake to respect its Kyoto target'.<sup>47</sup> As mentioned, in November 2006, nine out of ten proposed NAP II plans were rejected by the Commission. In three of these cases (Ireland, Sweden and Malta), this included the proposed use of JI/CDM credits. Overall, the Commission has cut seven out of 19 CDM plans, more than halving the plans of Ireland, Spain and Poland.

This specified and tougher line taken by the Commission can also be seen in light of alarming reports published in autumn 2006, indicating that member-states' planned use of JI/CDM credits at this point was 'significantly larger than the expected shortage' (of allowances).<sup>48</sup> This planned use indicated downward pressure on prices in phase two of the ETS and low incentives to abatement within the EU itself.<sup>49</sup> Hence, it is clear that how the member-states and the Commission further handled this issue is of substantial importance for the climate policy success of the ETS, and the possibility of seeing allowance prices rising to levels stable and high enough to spur substantial further abatement efforts in the EU. Somewhat paradoxically, the CDM factor may increase the willingness of governments to take on ambitious ETS targets, but in the implementation phase mean less abatement in the EU area. Hence, increased global (cost) effectiveness may go hand in hand with less reductions within the EU. This can be seen most clearly in the case of Germany, whose acceptance of the Commission's more stringent NAP II cap was accompanied (and domestically 'sweetened') by an increased planned use of CDM.

In conclusion, the link between the EU ETS and the climate regime's flexible mechanisms is insignificant in terms of explaining the level of ambition in NAP I. However, this factor has played and will play a more significant role in NAP II.

## Conclusion

How can we explain similarities and differences in the implementation of the EU ETS thus far? Our first proposition took a decentralized EU ETS as its point of departure and held that it would lead to low but varying levels of environmental ambition. We can see that this proposition has received significant empirical support. In line with the expectations displayed in Chapter 2, the member-states over-allocated the total number of allowances, and National Allocation Plans were delayed. Moreover, the

47 European Commission (29 November 2006), IP/06/1650, Emissions Trading: Commission Decides on First Set of National Allocation Plans for the 2008–2012 Trading Period (Brussels), 3.

48 WWF (November 2006), 'Use of CDM/JI Project Credits by Participants in Phase II of the EU Emissions Trading Scheme – A WWF Summary of the ECOFYS UK Report' (UK: WWF).

49 *Ecofys* (27 November 2006), 'Market Risks becoming Long', Press release.

differences in implementation appeared more striking than the similarities, indicating the importance of domestic-level explanations.

We singled out four key EU emitters – the UK, Germany, Spain and Poland – for more in-depth analysis. These countries varied in terms of implementation ambitiousness and they represented different geographical EU areas. Varying implementation could be explained by differences in institutional fit, differing needs for ambitious EU ETS implementation to achieve relevant EU or Kyoto targets, as well as climate policy 'drive'. However, our analysis also showed the significance of administrative capacity, especially in the case of Poland as well as the new Central and East European member-states. These countries had generally targets under the Kyoto Protocol which were generous, due to 'Berlin Wall fall' effects. Furthermore, they were also anxious to not let the EU ETS constrain their future economic growth.

Our second proposition took a centralized EU ETS as its point of departure and suggested that it would lead to generally high(er) levels of environmental ambition due to common EU criteria. The EU ETS was basically decentralized, and this led to a 'race to the bottom' dynamic among the member-states, since they had incentives to protect their own industries. This process was fuelled by short deadlines and uncertainty about the actions of others. However, the centralized line of thinking can contribute to our understanding of the implementation of the EU ETS, as the EU ETS includes elements of harmonization. The criteria for harmonizing the National Allocation Plans and the 'watchdog' role of the European Commission clearly pulled in the direction of less allowances and scarcity in the market. The Commission has rather quietly and almost unnoticed increased harmonization considerably in the NAP II process.

Our final proposition was concerned with factors at the international level. It held that low exposure to international competition and strong links between the EU ETS and CDM would pull in the direction of relatively high ambition levels. This proposition gained least support in our analysis, but international competition and inflow of allowances from CDM projects will probably become increasingly relevant in the future. First, it is true that industry opposition in general can shed light on the problems of achieving ambitious allocation and scarcity in the market. Industry in the UK, Germany, Spain and Poland lobbied to maximize their allocations under the EU ETS. However, the relevant sectors are not significantly exposed to global competition. Still, possibly much higher future allowance prices and the inclusion of the globally exposed aluminium sector in the ETS may act to increase the importance of this factor.

Second, CDM credits were not used for compliance purposes in the ETS pilot phase, even though the EU countries were formally allowed to do so from 2005. The reason was partly lack of incentives for using such credits in the over-supplied pilot phase, partly lack of capacity of the CDM's Executive Board to assess and approve projects, and in addition the lack of a formal link, as the global allowance registry has not yet started functioning. The issue of linking is, however, significantly more relevant in the NAP II process. The Commission has tried, with some success, to restrict the use of CDM credits in order to promote more abatement within the EU

area – at the risk of lowering the willingness of governments to take on ambitious ETS targets.

What about the prospects ahead? As noted earlier, although the NAP II process began with alarmingly low ambitiousness, the Commission has since succeeded in toughening up almost all NAPs so far assessed; roughly two-thirds of the EU NAPs. Allowances for the EU ETS's second phase are currently trading for around €18, so it is clear that the market has some confidence that the EU countries and the Commission will be able to deliver. However, analysts are far from certain that the necessary scarcity and related high and stable allowance price will come about. Not least the uncertainty related to the JI/CDM inflow into the market indicates that it may very well be the consulting and analyst part of the ET market that may look to the future with greatest confidence.

## Chapter 7

# Conclusions

The EU was initially sceptical to the inclusion of emissions trading in the Kyoto Protocol. How then can we understand and explain the subsequent initiation, decision-making and implementation of the EU Emissions Trading Scheme (ETS)? Why did the EU change its position on emissions trading? How did it manage to establish the world's first international emissions trading system so rapidly? And what are the results so far? These questions are interesting from both an empirical and theoretical point of view. Empirically, the EU ETS constitutes the first international emissions trading system in the world and the single most important climate policy instrument of the EU. How the scheme functions will thus have consequences for the EU's compliance with Kyoto targets and how the international climate regime will develop in the future.

In terms of theory, the EU ETS is an interesting case, as differing approaches and perspectives provide us with differing answers as to why and how the EU ETS developed. Intergovernmentalists will place main emphasis on the nation-state level, and explain the development of the EU ETS as a result of interstate bargaining. According to this approach, the EU member-states took the initiative and shaped the ET system in line with their interests and preferences. By contrast, scholars who hold that multi-level governance is the best lens for understanding EU policy will focus mainly on the EU level, but also point to the complexity of actors and institutions involved at various decision-making levels – non-state actors not least – when explaining what happened and why. According to this approach, the EU Commission took the initiative to the EU ETS, and the Commission and the European Parliament shaped the system, with input from non-state actors at EU level. Intergovernmentalist and multi-level governance approaches emphasize EU-internal factors and actors as the most important for explaining EU policy making. From the perspective of international regime analysis, however, the EU ETS may simply be a product of the international climate regime. According to this approach, which places main emphasis on the international level, the EU ETS initiative was taken as a response to the Kyoto Protocol, reflecting developments within the international climate regime and the international flexible mechanisms.

Stated in their extreme form, these approaches appear more competing than they actually are. They are in fact complementary, but highlight different decision-making levels, institutions, actors and mechanisms behind the development of the EU ETS. One central assumption of this book has been that the relative explanatory power of the various explanatory perspectives varies in the different policy phases. Another central assumption is that what happens in the initiation and decision-making phases will have important consequences for implementation – how the system will work in practice.