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Choosing Efficient Combinations of Policy Instruments for Low-carbon development and Innovation to Achieve Europe's 2050 climate targets

A Policy Exercise on the future of the EU Emissions Trading System

Workshop report



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1 Executive summary

This report presents the proceedings of the international workshop “A policy exercise on the future of the EU Emissions Trading System”, held on 16-17 October 2014 in Brussels in the context of the CECILIA2050 EU funded research project. The policy exercise aimed to advance knowledge and encourage discussion on key elements of the current debate about the reform of the European Emissions Trading System (EU ETS), thus helping understand the political feasibility of EU ETS reform options.

The exercise simulated simplified EU Council negotiations taking place in the year 2025 on re-design features of the EU ETS 5th trading period starting in 2031. Participants, who included senior officials from the European Commission (EC) and member states governmental agencies, as well as environmental NGOs, academia and think-tank representatives, were split in teams and asked to play the role of senior policy makers from the EC and seven European countries, namely Germany, Poland, Czech Republic, Italy, Spain, UK and Denmark.

The goal of the participants was to come to an EU agreement on a package of seven EU ETS design elements. Teams formed their initial position on the EU ETS design elements based on given role descriptions, a scenario, a number of options per each element, and their own knowledge and understanding of the problem.

During bilateral consultations and two rounds of Council negotiations, parties explored their differences in position as well as areas of convergence. Issues that were mostly discussed and that eventually made it into the final agreement include: a 3% linear reduction factor, focused free allocation to be phased out in 2040, price stability mechanisms, in particular a price trigger for the market stability reserve, and the use of EU ETS revenues for financing an Adaptation and Transition Fund for member states and carbon intensive industry.

The policy exercise included two debriefing sessions where participants could share their views on the experience. On the whole, the policy exercise method was felt to have worked well to enable lively exchange and substantive discussions while creating a fun and exciting experience. In terms of content, participants generally found the negotiation process reasonably similar to real life dynamics although rather simplified. However, the majority did not consider the outcome to be realistic. As from what has been learned, some participants reported to have a better understanding of negotiation dynamics and of the role and power of different actors in the process.

Three key observations can be drawn from the exercise. First, the exercise highlighted the major influence of the EC and of sound impact assessment studies for EU policy discussions and outcomes. As the exercise highlighted, the EC policy proposal steers the debate on specific policy options, thus leaving out of institutional arenas (e.g. the Council) issues that are prominent in informal discussions (such as bilateral conversations). Furthermore, the exercise showed the importance to parties of reliable impact assessment studies for sound decision making. In several occasions during the simulation participants felt they could not make decisions because they did not have sufficient understanding of the impacts of the



proposed options. Later on they reported that what happened in the simulation is quite realistic as in reality impact assessment studies are often perceived as not completely reliable.

Secondly, in agreement with the public policy literature, the exercise showed that it is easier to agree on policies whose distributional effects are hidden, namely an ambitious 3% LRF, because they are likely to be less contested. In contrast, policies whose impacts to specific societal groups are more evident such as the use of revenues and carbon leakage policies are more controversial because exposed to strong opposition. Negotiators who aim for an ambitious and environmentally effective EU ETS – but this applies to other policies too – may take advantage of this tendency to achieve their goal. However, because the implementation of generic policy goals is often problematic, achieving agreement on ambitious goals has more symbolic than substantial value.

Finally, achieving high environmental effectiveness via the EU ETS may significantly depend on lobbying capacity. The nature of the EU ETS is such that its environmental effectiveness is determined by a restricted number of decisions, such as those regarding the cap and the allocation, taken by a small number of agents. However, when decisions are concentrated in the hands of few agents, lobby groups can more effectively exercise pressure. Consequently, the capacity of lobby groups to influence decisions may significantly jeopardise, as it actually did in reality, the environmental effectiveness of the EU ETS. This may be different for other climate policy instruments for which a greater number of integrated mechanisms and criteria could contribute to environmental effectiveness. In the policy exercise, where lobby groups did not have an explicit role, countries were free to aim for ambitious goals in response to citizens' demand for climate action and eventually agreed on an ambitious cap and MSR. This was perceived as unrealistic. Indeed, the presence of lobby groups in the exercise may have led to a different outcome.

2 Introduction

This report presents the proceedings of the international workshop “A policy exercise on the future of the EU Emissions Trading System”, held on 16-17 October 2014 in Brussels. Section 2 provides information about the CECILIA2050 project and illustrates the purpose and background of the policy exercise. Sections 3 to 5 report in more detail on the discussion among participants and the outcomes of the workshop.

2.1 The CECILIA2050 project

CECILIA2050 is about “Choosing Efficient Combinations of Policy Instruments for Low-carbon development and Innovation to Achieve Europe's 2050 climate targets”. It is a three-year research project funded by the European Union’s (EU) 7th Framework Programme for Research (FP7). The project involves 10 European research institutes and is coordinated by the Ecologic Institute Berlin.

The project aims to advance knowledge on: 1) the performance and implementation of existing climate policy instruments and their interaction; and 2) how the European climate policy instrument mix should evolve to guide the transformation to a low-carbon economy. The project aims to investigate ways to improve the economic efficiency and environmental effectiveness of the instrument mix, and to address constraints that limit their performance and feasibility. These include public acceptance, political feasibility, availability of finance and the physical infrastructure, but also the administrative and legal framework.

The Institute for Environmental Studies - Environmental Policy Department of the VU University in Amsterdam coordinates the piece of research on the political feasibility of climate policy instruments. The goal of the research is to understand the interplay of interest groups’ preferences, power dynamics and institutions. This in turn helps identify possible areas of policy consensus and conflict – hence potential opportunities and constraints – for the adoption of instruments. Such an analysis has also potential to shed light on the criteria that have to be met for a policy proposal to be successful (i.e. adopted and effectively implemented). A mix of different qualitative methodologies were used for the research, including interviews, focus groups, on-line survey and a policy exercise (whose outcomes are synthesised in this report) with relevant stakeholders.

2.2 The CECILIA2050 policy exercise

The aim of the exercise

The CECILIA2050 policy exercise aimed to advance knowledge and encourage discussion on key elements of the current debate about the reform of the EU ETS. The exercise was designed to enable its outcomes to be used to answer specific research questions on the political feasibility of EU ETS reform options.

A major problem with the current EU ETS is that the system does not provide a sufficiently high price signal to EU industry to reduce carbon emissions. The EU addressed the problem of a low carbon price and the related issue of too many allowances on the market by back-loading allowances until 2018/2019 and by proposing the creation of a market stability reserve (MSR). Many claim that these solutions are not sufficient and that more radical reform of EU ETS is needed. Many reform options have been proposed, others may come into focus. But which options are politically feasible? The CECILIA2050 policy exercise was set up to help answer this question by pointing to political constraints and opportunities for the reform of the EU ETS. Specifically the CECILIA2050 policy exercise aimed to stimulate discussion around a number of key elements of the EU ETS design, namely *cap and allocation, resilience of the system, compensation measures to industry and member states, technical aspects such as trading period and carbon leakage, international measures and interaction with other policies.*

The format of the exercise

Policy exercises are intended to facilitate exploration of problems in which the set of relevant choices, important consequences, or key valued outcomes are contested or unclear. The reform of the EU ETS is one of such problems. We chose this method to investigate political feasibility primarily to elicit research data that is difficult to grasp with conventional qualitative research methods such as interviews and focus groups. Specifically, the policy exercise aimed to explore stakeholder patterns of interactions and power dynamics as two of the key dimensions of political feasibility in the context of the EU ETS reform. Secondly, by encouraging participants to actively engage and share their knowledge and experience, the policy exercise intended to advance participants' understanding of the problems surrounding the EU ETS reform.

The CECILIA2050 policy exercise simulated simplified EU Council negotiations taking place in the year 2025 on re-design features of the EU ETS 5th trading period that would start in 2031. The goal of the participants was to come to an EU agreement on a package of seven design elements of the EU ETS while attempting to secure the position of their own country.

Participants to the policy exercise included senior officials from the European Commission (EC) and governmental agencies of the countries represented in the exercise, environmental NGOs, think-tank representatives, and academics.

Participants were split into eight teams and asked to play the role of senior policy makers from the EC and seven European countries, namely Germany, Poland, Czech Republic, Italy, Spain, and Denmark. In principle, participants were assigned a role that was close to their real life position (so e.g. a German person would play in the German team). The set of countries was chosen to represent a wide range of different interests and agendas in the EU ETS negotiations. In addition, one participant played the role of the Commission's expert consultant. This person held extensive expertise on EU climate policy and was there to offer advice on the impacts of the policy proposal under discussion and to bring in the perspective of the foreign offices of the Commission on the global climate policy debate.

The role description, a narrative of the country/EC in 2025, depicted the socio-economic and political situation of the country, the status of the national climate policy and EU ETS, and the government's ambition and interests with regard to the reform of the EU ETS. The role description also provided information about the perspective of the national industry and environmental NGOs on climate policy.

Roles were designed such that each country was pursuing different EU ETS policy agendas¹ and had the possibility to form alliances with other countries on the different policy elements without making it easy to form a majority. The content of the role description was based on scientific publications (Solano and Drummond, 2014; Skovgaard, 2014) and was intended to be challenging, yet sufficiently realistic so that participants could easily embrace their role and act accordingly.

Participants were also confronted with a scenario set in the year 2025. The scenario included information about developments between now and 2025 concerning economic growth of different world regions, organization of the international climate policy regime and emission pathways, and climate policies of important world regions and countries (see Box 1). The content was informed by scenarios developed by the OECD (Johansson et al. 2012), the EC(Global Europe) and the IPCC (5th Assessment Report, WG III).

Two reasons justify the choice of situating the exercise relatively close to present time: 1) we did not want to prevent participants to act openly and creatively by situating the exercise too close to the current climate policy negotiations - the exercise took place one week before the actual negotiations of the Council of the EU on the 2030 Climate and Energy Policy Package; 2)at the same time, by not situating the scene too far away into the future, we wanted to ensure that participants could easily embrace the scenario as a realistic option unfolding from today's situation.

Box 1 The 2025 global and EU scenario

The scenario set a global context where, while the US implemented rigorous technology policies and the BRICS countries became major technology developers, the EU fell behind in key technology sector, because of a failure of its climate policies among other reasons. Especially the EU ETS was depicted as largely inefficient due to an insufficient price signal and no incentives for industry sectors to decarbonise as they could still benefit from exemption from the scheme. International cooperation in the climate regime was depicted as fragmented.

At the same time, the impacts of climate change were represented as increasingly apparent world-wide. In Europe agriculture and tourism in the South suffered extensive heat waves and droughts, while Central and Eastern Europe faced extensive flooding along the Rhine and in the Elbe basin. These events were told to have increased European citizens' awareness about climate change along with the pressure on the EU to upscale its climate policies.

¹Agendas were developed after the current socio-economic and climate policy situation of each country and the EU overall as well as the interests of key constituencies including industry and environmental NGOs.



The workshop was organized in three sessions: one session for the teams to form their initial position on EU ETS reform options, and two cycles of negotiation. During the first session teams were given EU ETS reform options in the form of coloured cards. Each colour represented one key EU ETS design element out of the seven that we identified. Each element comprised a number of reform options (4 to 7). Teams could freely pick, combine or come up with new options as the cards were primarily meant to trigger discussion about the EU ETS reform and were not intended to be exhaustive of the issue at hand. Teams formed their initial position by sticking the card of the selected options on the so called “position form”. They also had to fill in the so called “negotiation brief”, a document in which they laid down their negotiation strategy, including which options they considered negotiable/not-negotiable, which countries they wanted to consult bilaterally, and which negotiation approach they intended to adopt in the EU Council meeting. These documents, which could be revised in due course, accompanied the teams throughout the negotiations.

The second and third sessions were designed as two negotiation cycles of 2.5 hours each. Each cycle included bilateral consultations, in-country discussions and EU Council meetings. Only two elements of the cycle were fixed: duration of the whole session, and number of Council meetings, i.e. at least one per session. Teams were free to approach whomever they wanted to discuss bilaterally their position with a view to establish a draft decision that would serve as a basis for compromise. They also could choose to discuss internally their own position and strategy if needed.

The EU Council negotiation meetings had different chairs: the Czech Republic held the Presidency of the Council in the first session, and Denmark in the second session. Before the start of the first Council meeting teams were confronted with a number of external pressures, e.g. new scientific evidence about climate change, and major climate-related disasters, in an attempt to instil a sense of urgency to come to an EU agreement. At the beginning of the first Council meeting the EC presented its EU ETS reform proposal and countries were given the possibility to comment. The President of the Council chairing the meeting was free to decide how to conduct the negotiations, namely the proposal, discussion and voting of amendments and of the full package. The second Council meeting picked up negotiations from where they were left in the previous session. Voting rules were provided: qualified majority was required when the EC was in agreement with the proposed amendments; otherwise unanimity was necessary.

Two debriefing sessions were planned in the exercise to allow reflection on the experience, discussion and feedback. The first debriefing occurred in between negotiation cycles and consisted of a questionnaire that had to be filled in by each team. The second debriefing occurred at the end of the simulation and consisted of an individual questionnaire and a plenary discussion. In addition, a pre and post on-line survey was administered to the participants to collect data about participants’ perspective on EU ETS and on what they have learned through the exercise.

3 Discussions and Outcomes

3.1 Initial country positions

Teams were asked to play according to their role description. Roles were designed with the idea to stimulate discussion around specific policy elements and to offer countries the opportunity to form alliances while making it difficult for a clear majority to emerge. For example, on the use of EU ETS revenues, the Czech and Spanish governments were depicted with an interest in financial support for countries affected by climate related disasters, while the Polish government was told to be in search for support financing renewable energy and industrial transformation in Eastern Europe. On the other hand, the UK population was described as opposing any financial transfer to poorer or more in need member states and the government was told to be interested in support for green technology. On the compensation to national industries, Germany was depicted as a strong supporter. Poland, Italy and the Czech Republic were portrayed as not particularly keen on a stringent EU ETS policy, while Denmark and to some extent Germany and UK were in favour of more ambitious and effective EU ETS. Finally, the EC was represented as the honest broker between diverging interests in search for achieving the mid- and long- term EU emission targets by ensuring the right amount of allowances on the market and a reasonable carbon leakage policy.

Teams formed their initial position based on role descriptions, scenario and their own knowledge and understanding of the problem. Regarding *cap and allocation*, all countries focused on the issue of allocation, either free allocation (Poland, Germany, Czech Republic and Italy) or full auctioning (UK, Spain and Denmark) while the EC considered a significant adjustment of the cap (proposal of 3.0% yearly reduction) to be more relevant. Germany and Denmark were the only two countries who, next to allocation measures, also proposed an adjustment of the cap (2.5% yearly reduction).

In relation to the *resilience of the system*, teams proposed the adoption of price floor and/or ceiling and adjustments to the MSR. Germany, Spain, the EC and the Czech Republic opted for adjustments to the MSR (the Czech Republic supported no changes to the mechanism) to limit the volatility of the system and ensure inflow of revenues (the latter argument was supported by Spain). Poland, UK, Denmark and Italy opted for yearly adjusted price floor, ceiling or corridor, in light of the reasoning that this measure would bring long-term price predictability thus providing clear signal for investors. The UK wanted this to be a nationally implemented measure.

Compensation to industry and *compensations to member states* were particularly debated across teams and often linked to one another. Claiming for fiscal sovereignty and control over revenues, the UK asked for compensation to industry to be dealt with national rules and from national budgets and refused any compensation to member states. All other countries wanted some form of EU regulated redistribution of ETS revenues to industry and member states, with the exception of the Czech Republic who also wanted national control over



compensation to industry. Denmark, Poland and the EC opted for the establishment of a Transition Fund/Green Fund to stimulate low-carbon innovation either to apply across all EU industries (Denmark and Poland in favour of this idea) or only to industries prone to carbon leakage (Italy and the EC in favour of this option) throughout Europe. Germany pursued compensation for all EU energy intensive industry across member states. Italy requested both a Transition Fund and an Adaptation Fund to support adaptation in poorer, climate prone countries. The adaptation fund was also chosen by the Czech Republic and Spain as a measure to compensate member states prone to climate related disasters.

Regarding *technical aspects and timing*, three teams focused on technical aspects while the others regarded timing issues as more important. On technical aspects, Denmark and Italy requested EU-managed monitoring and reporting as means to increase integrity and reduce costs for member states. Spain, instead, strategically chose to oppose the adoption of any national measure in the ETS system as negotiation chip to use with the UK. All other countries and the EC focused on timing issues related to the trading period, and the revision of the carbon leakage list and the benchmarks. While the EC proposed to maintain the same 10 year trading period to ensure stability of the system, Germany opted for its significant shortening (4 years) along with the shortening to 4 years of the revision of the benchmarks, justifying these choices with the need to maintain the ETS system close to reality. A similar timeframe for the revision of the benchmarks was also proposed by the Czech Republic, while Poland and UK asked for shortening the revision timeframe of the carbon leakage list.

As *international measures* teams proposed several options: unlimited use in the EU ETS of international credits (Poland and Italy) versus no use of international credits (Germany); further linkage of EU ETS with other international trading schemes (Commission and UK); introduction of border tax adjustments to control carbon leakage and motivate third countries to take climate actions (Czech Republic); and purchase of EU allowances by exporters to the EU to cover their products' emissions, a variation of the border tax adjustment proposed by Spain to ensure revenues and prevent carbon leakage.

Finally, regarding the issue of *interaction with other policies* Poland, Spain and Italy were in favour of one carbon emission reduction target and no energy efficiency and renewable targets. In contrast, Germany and the Commission supported the alignment of the EU ETS with energy efficiency improvements through the withdrawal of 20% of EUAs from the market when the yearly estimated increase of energy efficiency in the EU is 5% beyond the modelled target. The Czech Republic and Denmark supported additional flexibility for governments through the introduction of trading of credits between ETS and non-ETS sectors. Finally, UK was not willing to support energy efficiency and renewable while at the same time in search for R&D support to technology innovation particularly in the field of CCS.

Figure 3-1 Country teams discussing their position



3.2 Commission proposal

Before the first round of Council negotiations the EC team presented the EC proposal resulting from internal and bilateral discussion (see table 3.1). As all other teams, the EC team was asked to put its position on record in the so-called position form and provide reasons for choosing the proposed measures. In the following their reasons are shortly elaborated.

The EC chose to increase the LRF substantially and to introduce a MSR in order to fulfil the EU long-term goal of reducing emissions by at least 80% by 2050. The combined effect of a more stringent policy with actions to limit the volatility of carbon price was considered as the foundation for the functioning of the EU ETS.

The reasoning behind the *Transition Fund* and the *European Green Industry Fund* targeting carbon leakage prone industries and poorer member states was to compensate the most vulnerable countries and sectors while pursuing an ambitious climate policy. Using ETS revenues for compensating vulnerable sectors and countries was considered a fair and equitable solution as long as these resources were put to constructive use for concrete actions to reduce carbon intensity.

Keeping the trading period at 10 years was seen as a reasonable compromise between the need for stability and the importance to leave the opportunity to revise the ETS system periodically.

The international measures were not fully developed but remained more at the level of general ideas such as linking to other countries' ETS, and collaboration to advance carbon pricing, clean technology deployment and removal of fossil fuel subsidies. It is worth noticing that all these measures were framed as "constructive engagement".

Finally, linking the EU ETS to the increase in energy efficiency was considered as a necessary action to ensure a positive interaction between the EU ETS and the energy efficiency policy, particularly when the latter performs better than expected.

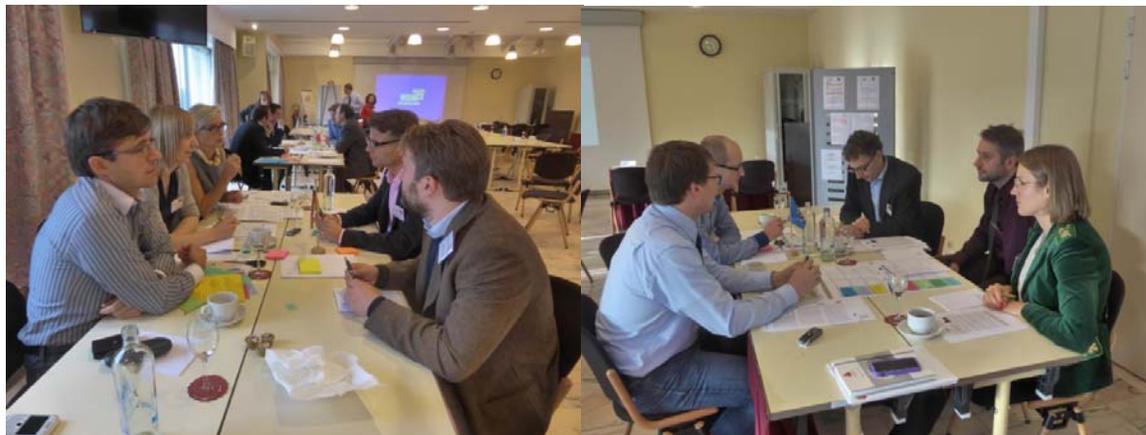
Table 3.1 The EU ETS reform proposal by the European Commission team. The proposed measures are shown (right column) for the seven design elements (left column) that were pre-designed for the participants.

Policy element	Proposed option
Cap & allocation	Changing the linear reduction factor (LRF) to 3%, starting in 2031
Resilience of the scheme	Market-stability reserve (MRS) withdrawing (releasing) 12% EU allowances (EUA) in circulation when EUA price $\leq 20\text{€}$ ($\geq 40\text{€}$) per ton CO ₂
Compensation to industries	<i>Transition Fund</i> from EU ETS revenues to stimulate low-carbon innovation in European industries prone to carbon leakage
Compensation to member states	<i>European Green Industry Fund</i> from EU ETS revenues for renewable energy and industrial transition in poorer and more carbon-intensive member states
Technical aspects & timing	Trading periods of 10 years
International measures	Links with other ETS. Work constructively with constituencies in 3rd countries to advance carbon pricing, clean technology deployment and removal of fossil fuel subsidies
Interaction with other policies	2% of EUA are permanently withdrawn when the yearly estimated increase of energy efficiency in EU is 5% beyond the modelled target

3.3 Negotiation process

The objective of the policy exercise for the participants was to come to an agreement on a package of seven EU ETS design elements by the end of the workshop. During bilateral consultations parties explored their differences in position as well as areas of convergence and built coalitions on key topics. Issues that were mostly discussed include: *mechanisms for price stability* (floor, ceiling, corridor, MSR adjustments), establishment of an Adaptation Fund for low income, climate change-prone countries and a Transition Fund for industry. Specifically, Spain talked to almost all other parties regarding the possibility to establish an Adaptation Fund, The Czech Republic had similar conversations about the establishment of a Transition Fund for industry, and Italy and Denmark engaged in discussions about price stability mechanisms. Also, The Czech Republic and Denmark, who held the Council Presidency, made sure to consult with the EC and with all other countries to get a sense of their priorities and main concerns in order to prepare their Presidency. Similarly, the EC consulted most countries before finalizing its position. As for alliances, Italy, Spain, Poland and Germany formed a coalition around the issue of ensuring industrial competitiveness, while the Czech Republic, Spain and Italy allied on the Adaptation Fund. Coalitions, however, changed as the Council negotiations progressed. Towards the end, for example, it became clear that Poland and Italy were aligned on the issue of offsets.

Figure 3-2 Country teams during bilateral consultations



Before the beginning of the Council meeting, parties were informed of recent press news. An EU Parliament press release informed that the EU Parliament had endorsed the EU ETS reform package proposed by the Commission. Also, media reported about several climate related disasters that had occurred in a number of EU countries, and the consequent citizens' protests demanding for urgent climate action. The rather extreme weather events built a general sense of urgency among parties to agree on a robust policy, which in the end helped the Danish Presidency to push some ambitious policy measures like the 3% LRF. Furthermore, as a consequence of the disasters that severely hit the country, the UK became more flexible on accepting an adaptation fund supported with ETS revenues.

During the first round of Council negotiations, chaired by the Czech Republic, the EC proposal was presented, countries had the chance to react on it and were subsequently asked to formulate up to 3 amendments to the proposal. The Presidency collected all proposed amendments and presented a progress report to the Council delegations.

Points of contentions immediately emerged around the questions of *cap and allocation*, *resilience of the system* and *compensation to industry and member states*. Although all countries acknowledged the need for tightening the cap, there was disagreement about the increase of the LRF, with Poland and the Czech Republic considering the EC proposal too ambitious especially if combined with no use of offsets and free allocation. Regarding the latter, the Commission proposal to bring to an end free allocation and instead establish a Transition Fund for carbon leakage prone industries found the opposition of Poland, Germany and the Czech Republic. Italy and UK contested the allocation of compensation funds to only low income or climate/leakage prone member states. Also, most countries considered the modalities of financing the compensation funds and the size of the funds to be fundamental issues deserving further discussion. Finally, on the resilience of the system, the Commission proposal about establishing a price trigger to enter/exit the MSR was opposed by Italy, Denmark and UK who preferred a real price collar mechanism (Italy) or a price floor (Denmark and UK). The only two issues that did not receive much attention – only one amendment each - were the international measures and the timing aspects. Basically everybody agreed with the proposal of linking the EU ETS to other emission trading systems

and to maintain the trading period of 10 years (only Germany proposed an amendment to shorten the trading period).

Figure 3-3 Country teams amending the EC proposal



The second Council negotiation round, chaired by Denmark, started with a senior analyst of DG Climate and Energy raising some observations on the potential impacts of the policy package under discussion. The analyst raised concerns about the consistency of the proposal with the objectives of the climate package in terms of emissions reduction. He also stressed the fact that the weaker the package and the associated carbon price, the longer will be the dependence on state subsidies for renewable energy and the more difficult will be for CCS technology to come to maturity. This information did not have much influence on the discussion and the negotiations.

Subsequently, the Danish Presidency tabled three issues of the package which seemed important to several countries and still quite controversial. These were the *establishment of an Adaptation Fund*, the issue of *MSR versus ceiling/floor price*, and the *3% LRF*, the only issue for which there seemed to be emerging consensus. Parties while reaffirming their priorities, showed willingness to compromise and come to an agreement on these issues, yet felt that they needed more bilateral and Council discussion.

At this point the senior analyst of the Commission Foreign Service offices provided his inputs on the current international climate policy context. He reminded the Council of the recent unsuccessful international negotiations and the parallel emergence of a group of countries – including China, Thailand, South Korea, South Africa, Mexico, and a substantial number of US and Canadian states – working together towards the adoption and extension of carbon pricing mechanisms worldwide (so called carbon pricing club). He also pointed out the emergence of a problem in the international arena related to free allocation of allowances as China had the intention to take the EU to the World Trade Organization on ground of unfair and illegal subsidies. On this issue China tabled a proposal including border adjustment measures to non-members of the carbon pricing club and full auctioning. This information raised some discussion among parties, and led parties to agree on phasing out free allocation by 2040 and to introduce a review mechanism to pre-empt the concerns of the carbon club members and avoid a WTO law suit while transitioning to full allocation.

Right after the speech of the senior analyst, the Presidency called off the meeting to prepare a revised proposal in consultation with the Commission and to give parties time to bilaterally discuss. When parties reconvened, the Presidency illustrated the full package and opened the discussion of the last round of negotiations. The issues that at this later stage received attention were that of *offsets, free allocation, Adaptation and Transition Fund, and price mechanisms*. Regarding the funds and the price mechanisms, positions remained substantially unchanged apart from an opening of Poland to vote in favour of the package if the MSR ceiling was lowered to 30 Euro. The Polish proposal, however, was unacceptable to most countries. As for the funds, parties remained concerned with the actual amount of resources that would be available. Also, in reaction to the announcement of the EC foreign service analyst, parties also raised a concern about the feasibility of the transition fund which they feared it might be taken before the WTO on ground of illegal subsidy. The implications of free allocation were discussed in connection to the availability of resources for the funds and the potential risk of incurring in a lawsuit with WTO. As for offsets, Italy and Poland requested the use of offsets to counterbalance the tightened cap and the price increase that would result from the proposed package. The proposal however did not envisage any change in the offset policy other than allowing offsets in the context of linked ETS systems – which some questioned were real offsets.

Towards the end of this final round of negotiations the Presidency put quite some pressure on parties to reach an agreement by cutting discussion time and calling for a vote on the full package, which had the endorsement of the Commission. Parties, who felt the pressure, were not particularly happy with this approach as they clearly needed more discussion. Eventually a qualified majority emerged and the package was approved with the dissenting vote of Poland and Italy. The two countries felt that the tightened cap and the price increase resulting from the policy were not counterbalanced with adequate measures such as the use of offsets. An attempt of the Presidency to convince them to vote the package failed.

Figure 3-4 Parties during the EU Council meeting



3.4 Negotiation outcomes

Table 3.2 summarizes the content of the EU ETS policy package approved by the parties with qualified majority. The table also includes participants' evaluation, on a scale from 0 to 5, about the likelihood that the approved package would be adopted in reality in 2025. In the following, the main points of discussion regarding the final package are briefly reviewed.

With surprisingly little dispute, countries agreed on keeping the Commission proposal to increase the LRF to 3% starting in 2031. However, this design feature was not considered very realistic as it received a score of only 2.7 in terms of likelihood to be adopted in reality.

During early bilateral consultations, some sort of price control – as, for example, a price corridor – was very prominent in the discussion. This point was picked up by the Commission that proposed a mechanism linking the MSR to the price of allowances. From that moment on, the debate on price control focused on the MSR. The actual price levels that would trigger the withdrawal/release of allowances were highly controversial. The proposed ceiling price of 50€, arranged between the Danish Presidency and the Commission behind closed doors, was higher than most member states wanted. This triggered substantial opposition, to the point that, as explained earlier, it became a reason for Poland and Italy to vote against the package. The measure was eventually accepted by the majority of the countries when it was decided to review the MSR parameters after one year of implementation. Similarly to the case of the LRF, participants did not regard the final design of this measure as likely to be adopted in reality (score of 2.2).

The use of EU ETS revenues was a topic of major discussion during bilateral consultations and Council negotiations. Countries exhibited great interest in using the revenues for tackling problems that were high on their national agenda. In the end, member states agreed to establish a mixed adaptation and industrial transition fund, split 50/50%. Interestingly, the topic of adaptation persisted in the discussion and eventually made it into the package although it had not been included in the initial Commission proposal. Participants judged this measure more likely to be adopted (score: 3.8) than the price and cap measures.

Connected to the establishment of the fund was the issue of whether only low income member states should be entitled to access to the fund. The UK, who firmly opposed EU centralized management of ETS revenues, accepted the establishment of the fund only after the country was included in the group of potential recipients. This decision was triggered by additional information that was provided during the policy exercise on climate change related disasters occurred in UK and other countries, and the concession that the transition part of the fund would have supported also CCS technology of which UK is a major producer.

Finally, to support carbon leakage prone industries the package envisaged free allocation to be phased out in 2040. Despite a number of countries pushing for free allocation, the news that WTO would regard free allocation as a protective measure led parties to decide for phasing out free allocation by 2040 the latest. This measure was judged as fairly realistic (score: 3.4).

Table3.2: The final agreement package. The right column shows how likely the participants evaluated each design feature to be adopted in reality (from 0 – very unlikely to 5 – very likely).

Policy element	Proposed option	Likelihood of the option to be adopted in reality
Cap & allocation	Changing the LRF to 3%, starting in 2031.	2.7
Resilience of the scheme	MRS withdrawing (releasing) 20% EUA in circulation when EUA price $\leq 20\text{€}$ ($\geq 50\text{€}$) per ton CO ₂ with the price triggers increasing by 3% each year.	2.2
Compensation to industries	Focused free allocation to carbon leakage prone industries. To be phased out by 2040.	3.4
Compensation to member states	Fund from EU ETS revenues to support by 50% renewable energy and industrial transition (and CCS) as well as climate change adaptation.	3.8
Technical aspects & timing	Trading periods of 10 years. Benchmark review every 5 years.	3.9
International measures	Links with other TS/ -Work constructively with constituencies in 3rd countries to advance carbon pricing, clean technology deployment and removal of fossil fuel subsidies.	4.5
Interaction with other policies	National energy efficiency targets.	3.0

4 Debriefing: participants' reflections on process and outcomes of the policy exercise

The policy exercise was followed by an individual debriefing session where each participant had to fill in a questionnaire, and a plenary debriefing session; a debriefing session took also place in between the two negotiation rounds, when teams were asked to fill in a group questionnaire. The goal of the sessions was to enable participants to share their views on the outcomes of the day and their wider implications, as well as their personal experience with taking part in a policy exercise.

In terms of *content*, participants generally found most of the elements of the final agreement on the EU ETS reform to be unrealistic. For example, the 3% LRF was felt too ambitious to be adopted in reality. The price trigger of 20/50 Euro for the MSR was also considered unfeasible. As one participant observed “In practice it would be nearly impossible to get agreement on prices from the different countries, industry lobbies, parliament, etc.” Another person noted that “the relation between volume and price is still very unclear in the ETS discourse – problematic”. In contrast to these views, a number of participants found the final package quite similar to the status quo, rather weak and unambitious, apart from the LRF, and for that reason quite realistic. A number of policy options were considered more realistic. These include the establishment of an adaptation and transition fund, the pursuing of linkage between EU ETS and international emission trading systems, and the trading period of 10 years with benchmark revision every 5 years.

Participants generally found the *negotiation process* reasonably similar to real life dynamics, although rather simplified. On a scale from 0 to 5 participants evaluated the degree of realism as 3.2. As one participant explained “It [the negotiation process] reflects the fact that it is hard to find a solution and that each one has to give up something”. Differences were reported about the limited time available to build trust and coalitions with other parties and to understand the complexity of the issues. As most participants identified forming coalitions as a major opportunity to achieve their goal, lack of time was perceived as a barrier in the negotiation process. Indeed, many reported frustration due to time pressure. On the other hand, time constraint was felt as inevitable in an exercise like this. Similarly, although perceived as inevitable, the simplification of the EU and national policy making complexity was reported by a number of participants as unrealistic. For example, the interaction between the Council Presidency and the Commission was considered less dynamic than in reality. Also, some highlighted that in domestic policy making there would be much more explicit understanding of where the political opposition comes from and why it arises in terms of internal politics. As one participant put it, “I think the political pressure makes this a lot harder in real life”.

As from *what has been learned*, participants reported to have a better understanding of how negotiations work, and of the role and power of different actors in the process, particularly with reference to the implications of the right of policy initiative held by the EC. Some quotes



are explicative of these elements: “negotiation is an art”; “It has helped me to better understand why certain member states or constituencies have more power than others. And how important that is to outcomes. Also the extent to which simplicity is key to achieving a deal”; “More aware of how negotiations might take place in reality. The power that the presiding country has on the overall negotiations, and also the importance of offering some benefits to MS opposing proposals (to get them on board)”; “The Commission has enormous power in its right of proposal. This shapes the entire contours of the debate thereafter. So you need to get the Commission on your side early if you want to achieve something”; “It served as a reminder that, in some countries (such as Germany, Poland, UK), the ETS takes centre stage in thinking about climate policy. In other countries, it is probably considered as one policy tool among many, not necessarily the central, overriding tool”. A number of participants found the learning experience to be potentially useful in their professional life, especially with regard to the importance to listen to different positions and be open to compromise.

On the whole, the *policy exercise method* was felt to have worked well to enable lively exchange and substantive discussions while creating a fun and exciting experience. Some participants expressed the opinion that the objective of the exercise should have been clearer while others would have liked to have had another negotiation round. In general, the scenario and the role description were perceived as a fairly realistic guidance, sufficiently open to allow room for manoeuvring during the negotiations. One participant, however, noted that “The exercise, and strategic priorities, encouraged a rather partial perspective - it was not necessarily in the MS' concern to keep the big picture in mind, and think through all consequences of changes they required, and whether these would be consistent with overall policy goals.” Overall, participants found the exercise useful to understand policy making dynamics and suggested to extend the use of this method to, for example, energy policy, and working groups within the EC. One person suggested conducting a similar exercise specifically for the issue of the MSR.

5 Conclusion: reflections on key findings of the policy exercise

The CECILIA2050 policy exercise aimed to advance knowledge and encourage discussion on key elements of the current debate about the reform of the EU ETS. In the following a number of key findings are discussed.

Participants easily embraced a scenario that depicted a non-functioning EU ETS. The fact that all participants could easily accept a scenario wherein 2025 the EU ETS still does not work effectively indicates that this is a likely possibility in the mind of the policy exercise participants. At the same time, the lively discussion that took place during the exercise, show understanding of problems and interest to identify solutions to improve the functioning of the instrument.

Different negotiation styles led to different reactions of countries. Both Council presidencies were effective in advancing the negotiations, although the effect of their approach was substantially different on parties. While the Czech presidency was open to discuss all elements of the package and strived for consensus, the Danish presidency, under time pressure and urgency to reach an agreement, chose to focus on few elements of the package and was not able to allow for discussion on all policy elements. In general, the Czech approach created a sense of constructive, collaborative discussion, while the Danish approach led to frustration in the teams. These dynamics highlighted the importance for successful negotiations to acknowledge each nation's position and ensure that all parties feel their concerns heard and taken into consideration. When this is not the case, frustration and opposition may arise and trust may be undermined. Even when an agreement is eventually reached, these feelings can affect the subsequent discussions on technical and implementation aspects of the policy.

Parties showed high interest to use EU ETS revenues for climate mitigation and adaptation purposes in all member states. As negotiations moved in the direction of a stricter EU ETS policy, countries seized the opportunity to call for a focused use of the EU ETS revenues. All countries but UK showed interest in an EU centralized management system of revenues with equitable redistribution to all member states rather than allocation to only low income or highly vulnerable countries. Later on, the UK also joined the group as result of having been affected by climate related disasters. This discussion led parties to agree on the establishment of an Adaptation and Transition Fund whose likelihood to be adopted in reality was evaluated 3.8 out of 5. Although this policy option may be appealing to most EU countries, institutional barriers, above all the fact that the EU does not have power on fiscal matters, stand in the way of the actual adoption of such a policy.

It is easier to agree on policies whose distributional effects are hidden than policies whose impacts are more evident. Country teams could relatively easily agree on an ambitious 3%LRF while the use of revenues and carbon leakage provisions proved more controversial topics. On the one hand, this may be partly explained by the design of the exercise as the role descriptions included information on the country's political interests in the climate negotiations, and consequently partly steered the discussion towards certain issues. On the

other hand, this outcome is consistent with findings in the public policy literature. Scholars in this field, in fact, suggest that it is easier to agree on policies whose distributional effects are hidden because they are likely to be less contested. In contrast, policies whose impacts to specific societal groups are more evident are exposed to strong opposition. This latter interpretation finds support in the outcome of the EU Council negotiations on the 2030 package that took place shortly after the policy exercise. After having postponed the approval of the package for months, the Council decided on the 2030 emission targets, whose distributional impacts are not immediately apparent, but still struggles to come to a decision on key elements that have more visible effects on societal groups. In principle stakeholders who aim to ambitious environmental effectiveness of the EU ETS – but this applies to other policies too – may take advantage of this tendency of easily achieving agreement on generic policy goals to push their agenda. However, because the implementation of generic policy goals is often problematic, achieving agreement on ambitious goals has more symbolic than substantial value.

Achieving high environmental effectiveness via the EU ETS may significantly depend on lobbying capacity. The environmental effectiveness of the EU ETS is determined by a restricted number of decisions on key parameters, such as those regarding the cap and the allocation, taken by a small number of agents. Thus, in principle, to ensure high environmental effectiveness it would be sufficient to build consensus around ambitious objectives for these parameters among these few agents. However, as New Institutional Economic scholars suggest, when decisions are concentrated in the hands of few agents, lobby groups can more effectively exercise pressure than when decisions are dispersed on many agents. Consequently, the capacity of lobby groups to influence decisions may significantly jeopardise, as it actually did in reality, the environmental effectiveness of the EU ETS. This may not be the case of other climate policy instruments where a higher number integrated mechanisms and specific criteria could contribute to environmental effectiveness. The role of lobby groups in the EU ETS design was to some extent reflected in the policy exercise. Because lobby groups did not have an explicit role in the exercise, countries were not under strong lobby pressure – only some information about key interests of industry and environmental NGOs was provided in the role description. Contrary to what often happens in reality, country teams were free to aim for ambitious goals in response to citizens' demand for climate action and eventually to agree on an ambitious cap and MSR, the key parameter of environmental effectiveness. Indeed, some participants stressed the importance of having lobby groups represented in the exercise to increase realism.

The European Commission has major influence on the discussion about policy options. Several topics were prominent in the early bilateral consultations and disappeared from the discussion after they were not picked up by the Commission proposal. One example of this sort is represented by the compensation rules for indirect costs. Initially a number of low income countries demanded level playing field on this issue, something on which high income countries such as Germany were willing to consent. However, later conversations focused entirely on the Commission proposal where this topic was not included. This shows, in line



with what participants also reported, that the right of policy initiative gives the Commission major power to steer the debate on specific policy options, by at times cutting out of institutional discussions (e.g. in the Council) issues that are prominent in informal discussions (e.g. bilateral conversations). Consequently, as participants have also reported to have learned, if stakeholders want to insert their policy ideas into the debate, they should engage in discussions with the Commission at early stages of the policy process.

Reliable information about the potential impacts of different policy options is crucial to sound decisions. A problem that emerged during the exercise and that is found often in real climate policy decision making is the lack of reliable assessment studies about the impacts of the policy options under discussion. In several occasions during the simulation participants felt they could not make sound decisions because they did not have sufficient understanding of the impacts of the proposed options. Later on they reported that what happened in the simulation is quite realistic as often in reality the Commission impact assessment studies are perceived as not completely accurate and reliable. As decisions are based on impact assessment studies, consensus on their reliability and relevance is a precondition to successful negotiations.

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Annex A – List of participants

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