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## Skating on thin ice: Europe's internal climate policy and its position in the world

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### ABSTRACT<sup>1</sup>

On 11 and 12 December the EU Summit may seal an historic agreement on the climate action and renewable energy package. At the same time the UN Climate Summit in Poznań is drawing to a close. The EU hopes Poznań will give a strong and positive signal to ensure negotiations on a post-Kyoto climate change agreement will be concluded at the UN Summit in Copenhagen next year. Being the driving force within the international climate negotiations, the EU's leadership role hinges to a considerable extent on what it can achieve at home and hence in this case on what will happen at the EU Summit in Brussels. This new paper discusses the EU's international climate change position and its relations with domestic climate change policies. Issues discussed are the role of the emissions trading scheme in the international carbon market; the potential use of trade measures by the EU when trading partners do not take up a carbon commitment; and specific design choices of the EU policies with relevance to the international negotiations, such as the new baseline year to measure emissions and a distribution of efforts on the basis of the prosperity of member states. The paper moreover discusses how the EU conducts climate negotiations and argues the sophisticated system may not be sustainable when the EU's leadership role in the climate negotiations will come under pressure.

### 1. INTRODUCTION

The entry into force of the Kyoto Protocol, despite US opposition, is generally considered a key diplomatic success for the EU. Negotiating a successor to the Kyoto Protocol that expires in 2012 is now a top priority in Brussels. It is politically important because EU leaders and EU citizens are sincerely concerned about climate change. Working towards an effective international and European climate change policy has moreover become a key issue to demonstrate the added value of European integration. On top of that, there are clear synergies with the EU's concern about its reliance on fossil fuels from third states and its ambition to reduce fossil-fuel related emissions. This is why it should not surprise that the EU has taken

<sup>1</sup> An earlier draft of this paper was presented in Brussels at the Consent workshop on an integrated energy policy. The authors would like to thank Carlo Trojan for his useful comments on the paper.

a firm position in what is called the post-2012 climate negotiations and is willing to reduce greenhouse gas emissions by 20 %, even when other industrialised countries would not take up a comparable commitment.

Reaching an ambitious international agreement that will lead to deep emission cuts cannot be taken for granted. Although climate change certainly has become a more important issue for countries all over the world, and has featured prominently on the agenda of a large number of high-level international meetings, the EU remains the driving force behind the international climate change negotiations. But, even within the EU it is still an open question how the current financial crisis will affect the political support for climate change policies. There is moreover a lot of uncertainty with regard to the position the new US government will take in the international climate negotiations, and to what extent other countries are willing to commit to the more steep reduction levels the EU is advocating.

Most importantly, whether the EU will succeed in convincing other countries to follow its course will depend to a large extent on its ability to demonstrate that it is possible to achieve greenhouse gas emissions domestically without compromising economic growth. It will also depend on its ability to play the role of 'honest broker' and create a coalition between the developed countries, in particular the United States, on the one hand and the developing countries, whose support has proven insurmountable in the past, on the other hand. In that respect it is important to realise that the developing countries consider that more developed countries, such as the EU Member States, should offer financial means for climate change adaptation and their transition to a low-carbon economy.

Climate change, by definition, is a EU policy area where the internal and external dimensions are strongly interwoven. This is reinforced by other elements, such as the linkage between emission credits obtained by reducing inside the EU and those obtained from projects in developing countries, the innovation push EU policies can possibly have on a global scale, and the possible use of trade measures vis-à-vis countries not willing to take up a carbon reduction commitment.

This contribution will discuss the EU's international climate change position and its relations with domestic climate change policies. The main focus is on mitigation policies that reduce greenhouse gas emissions and not on adaptation policies that are needed to cope with the consequences of climate change. With regard to the mitigation policies the focus is on policy instruments used such as the EU emissions trading scheme. However, it is realised that a much broader set of government policies, as well as other factors such as the price of oil, influences whether the European Union, and other parts of the world, will quickly and cheaply make the transition to a low carbon economy.

## 2. THE IMPORTANCE OF CLIMATE CHANGE POLICY FOR THE EUROPEAN UNION

The EU is often portrayed as the saviour of the Kyoto Protocol. After the withdrawal of the United States in 2001 the EU stood united and convinced Japan, Canada and Russia to continue with ratification. This was needed to ensure that the threshold for entry into force would be reached. Due to this successful diplomatic endeavour, the Kyoto Protocol entered into force in 2005<sup>2</sup>. The EU's historic activism in the climate change negotiations can be understood by a number of factors.

First of all, European politicians, or at least a considerable number among them, appear to be truly concerned about the threats to human kind posed by climate change. They are firm believers of the scientific evidence presented by climate scientists gathered within the Intergovernmental Panel on Climate Change (IPCC). EU citizens also consistently rank climate change among the issues of high concern to them<sup>3</sup>. The attention given to Al Gore's movie "An inconvenient truth", the Stern report on the economic impacts of climate change, and the fourth assessment report of the IPCC all contributed to a growing concern among European populations.

Secondly, the Kyoto Protocol embodies almost all the European Union believes in, most importantly that it is possible to address a problem of the commons by means of inter-state cooperation. The EU's international climate agenda links in with the EU's ambition for effective multilateralism and sustainable development. At the same time, backing so strongly the Kyoto Protocol proved an opportunity to demonstrate Europe's preference for a different course, than the unilateral one advocated by the Bush government of the US. Moreover, international climate change policy proved an issue where the EU managed to stand united. Together with the EU support for the International Criminal Court it has often been mentioned to demonstrate that the EU can act with a single voice in international foreign policy issues, in contrast to its divides over the Iraq war and more recently the separation of Kosovo.<sup>4</sup>

Thirdly, climate change increasingly has been used as a vehicle to address energy security concerns. Reducing greenhouse gas emissions to a large extent is intimately linked to reducing the use of (imported) fossil fuels. The European Union is, and increasingly will be, an importer of fossil fuels. These for the larger part stem from countries it not always feels comfortable with. When Putin's Russia closed gas pipelines to neighbouring countries in 2006, many feared Russia would increasingly use energy as a political weapon. The EU's security of supply position by then had

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<sup>2</sup> Cf. Oberthür, S. and C. Roche Kelly (2008), EU leadership in International Climate Policy: Achievements and Challenges, in: *The International Spectator*, Vol. 43, No. 3., September, pp. 35-50.

<sup>3</sup> Special Eurobarometer 300, Europeans' attitudes towards climate change, September 2008.

<sup>4</sup> M.L.P. Groenleer and L.G. van Schaik, *United We Stand?*, The European Union's International Actorness in the Case of the International Criminal Court and the Kyoto Protocol, *Journal of Common Market Studies*, 2007, 45(5), pp. 969-998.

already become a key issue. Rising oil prices fuelled the already existing fear that the end of oil and gas reservoirs is near. As a consequence, while EU Member States have always been reluctant to hand over policy-making authority over the choice of energy sources, it makes absolute sense to them to improve their dependency on imported fossil fuels by increasing energy efficiency and shifting to renewable energy.

Fourthly, climate change became in a way a saviour issue for the EU itself. In 2005 the EU was almost in a desperate need for an appealing subject through which it could justify its added value to European citizens. The European integration project had come under serious pressure, most pronounced by the two negative votes on the European Constitution in EU founding states France and the Netherlands. Politically, it became almost impossible to continue discussions on institutional reform. Instead, it was considered more appropriate to focus on concrete projects where “Brussels” could show its ability to solve pressing cross-border policy problems, such as climate change. Still today, with the uncertain future of the Lisbon Treaty, climate policy remains at the heart of the European project.

The above-mentioned reasons do not only explain why the EU can act as an international leader on climate change issues, but also why it can put forward ambitious climate change policies within the EU. It is important to realise though that some of the factors are rather unique to the EU, and that although climate change has gained in importance in other parts of the world, it nowhere is politically as important as it is in the EU. The international climate change agenda is largely a European agenda. This is perhaps most obviously demonstrated by the fact that the Secretariat of the UNFCCC is hosted in Bonn, Germany, and that two forthcoming UN Summits will be hosted in EU Member States: in Poznan, Poland, in December 2008 and in Copenhagen, Denmark, in December 2009.

### 3. THE EU'S INTERNATIONAL POSITION ON CLIMATE CHANGE

The EU clearly was a driving force at the most recent UN Climate Summit in Bali in December 2007. After intense and chaotic negotiations, the EU delegation, supported by other delegations, successfully managed to get the US aboard of the so-called Bali Action Plan. This plan provides a roadmap for the negotiations on a post-2012 international climate change agreement. The launch of the post-2012 negotiations and the setting of a deadline for their conclusion at the UN Summit in Copenhagen in 2009 was in line with the objectives set itself at the European Council meeting in March 2007. In this meeting the EU not only agreed upon the famous triple 20 goals regarding emission reductions, renewable energy and energy efficiency<sup>5</sup>, but also outlined a list of elements to which a future international agreement on climate change should adhere<sup>6</sup>:

<sup>5</sup> The EU The Spring European Council of March 2007 was crucial, as it set ambitious EU goals to tackle climate change and to achieve secure, sustainable and competitive energy. European Heads of State and Government set

- The development of a shared vision to reach the ultimate objective of the UN Framework Convention on Climate Change
- The strengthening and extension of global carbon markets
- The development, deployment and transfer of the necessary technology to reduce emissions
- Appropriate adaptation measures to deal with the effects of climate change
- Action on deforestation
- Addressing emissions from international aviation and maritime transportation

This position is reiterated and specified in further detail in a number of Council Conclusions drawn up in the Environment Council<sup>7</sup> and in specific EU submissions for the negotiations which are ongoing within the context of the United Nations Framework Convention on Climate Change (UNFCCC). These consist of the forthcoming UN Summits in Poznań and Copenhagen and a number of smaller meetings, such as the climate talks that were organised in 2008 in Bangkok, Bonn and Accra.

### 3.1. A shared vision

The EU has a long-term vision that the earth's global surface temperature should not rise more than 2 degrees Celsius in comparison to pre-industrial levels. The 2 degrees target would present a tipping point. When the temperature rise would be higher this would create irreversible damage and set in motion further deteriorating processes. To a certain extent the 2 degrees target is set in an arbitrary way (i.e. why not 1.8 or 2.2 degrees?), and is thereby a political choice and objective of the EU. It is not subscribed to by most other countries.

The importance of setting a shared vision in terms of a maximum increase in temperature rise at global level is that such a level corresponds with emissions scenarios in the IPCC's forecasting. For the EU it is important to achieve reduction efforts that are commensurate with the scientific finding of the IPCC. Agreeing upon a maximum temperature increase, in combination with acknowledging the scientific findings of the IPCC, implies taking a scientific approach to deciding on reduction targets. This may avoid horse trading over

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three key targets: a reduction in the EU's overall level of greenhouse gas emissions of at least 20 % below 1990 levels by 2020 – rising to 30 % in case of a future international climate agreement; a 20 % share in the EU final energy consumption by 2020 and an energy efficiency improvement of 20 %.

<sup>6</sup> European Council (2007), Presidency Conclusions, 8/9 March.

<sup>7</sup> The most ones are the following: Council Conclusions on the preparations for the 14<sup>th</sup> session of the Conference of the Parties (COP 14) to the United Nations Framework Convention on Climate Change (UNFCCC) and the 4<sup>th</sup> session of the Meeting of the Parties to the Kyoto Protocol (CMP 4) (Poznań, 1-12 December 2008), 2898<sup>th</sup> Environment Council meeting, Luxembourg, 20 October.

the overall emission reduction objective. In the Bali Action Plan countries have recognised the need for deeper cuts in global emissions and to address climate change as indicated in the Fourth Assessment Report of the IPCC. A footnote reference was made to the IPCC work in which the reduction numbers are given.

Another consequence of setting the 2 degrees target is that it provides scientific information for what the EU should do itself in terms of emissions reductions. The IPCC has translated the 2 degrees target as meaning a 25-40 % reduction for developed countries in 2020 and a 80-95 % reduction by 2050. The EU calls for developed countries to commit to collectively reducing their emissions of greenhouse gases in the order of 30 % by 2020 compared to 1990. They should do so with a view to collectively reducing emissions by 60 % to 80 % by 2050 compared to 1990.<sup>8</sup> For the economically fast-growing developing countries it has called for a 15 % reduction in 2020 in comparison to business as usual projections.<sup>9</sup> The EU is willing to reduce its own emissions by 30 % in 2020 “provided that other developed countries commit themselves to comparable emission reductions and economically more advanced developing countries to contributing adequately according to their responsibilities and respective capabilities”.<sup>10</sup> When others will not do this, the EU has indicated that it will still reduce its own emissions by 20 %.

### 3.2. Targets and trading

In terms of commitment the EU argues for “absolute emission reduction commitments as these are the backbone of a global carbon market”.<sup>11</sup> When choosing for emissions trading it makes sense to argue a target is needed. Without having a firm cap it is difficult to make the price estimates needed in order to trade emissions, which may reduce incentives to innovate into low carbon technologies. It could lead to a continuing pressure to relax the cap. It will also make it difficult to link domestic emission trading schemes, such as the ETS, to other schemes. The EU is furthermore keen on agreeing on legally binding reduction targets since it believes this to be the only way to really ensure that reductions will occur. The EU’s preference for a “targets and trading” approach may however obstruct progress in the negotiations as important negotiating partners, such as China, India and Japan, and others have stated openly their opposition to legally binding absolute greenhouse gas reduction targets.<sup>12</sup> Even the US Obama government is unlikely to be enthusiastic about committing to legally-binding targets at the international level,

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<sup>8</sup> Presidency Conclusions March 2007.

<sup>9</sup> Council Conclusions, October 2008.

<sup>10</sup> Presidency Conclusions March 2007.

<sup>11</sup> Presidency Conclusions March 2007.

<sup>12</sup> Höhne, N., Meira Filho, G., Marcovitch, J., Yamin, F. and S. Moltmann, History and status of the international climate change negotiations on a future climate agreement, Basis workshop future international climate policy, 2006.

particularly when it would be a much more stringent than a target set in a domestic cap-and-trade system.<sup>13</sup> Copenhagen in this respect may come too early.<sup>14</sup>

Alternative approaches may be sectoral targets, a commitment with regard to policies and measures (the “pledge and review” approach), and softer ways of setting targets. These are for instance “no lose targets”, which state a maximum level of emissions under which developing countries need to stay in order to be eligible to participate in the carbon market, and the use of “a safety valve”, a maximum price on allowances.<sup>15</sup> The EU seems not very much convinced of the merits of such approaches as they do not guarantee reductions in quantitative terms. But, in order to reach a deal it may have to accept such alternatives to the targets and trading approach. An approach to which it is more favourable are the sectoral targets that could be agreed upon for certain industry sectors, which are active in only a limited number of countries, and truly operate and compete on the international plane (e.g. the steel sector). Developing countries are less enthusiastic. They accuse the EU and other industrialised states for using sectoral targets as a means to impose reduction targets upon them.

A meaningful participation by developing countries is however not only dependent upon the type of commitments. It is hampered most of all by their declared position that US participation is a *conditio sine qua non*. Developing countries are unlikely to accept binding commitments until and unless the US also does so. The US on the other hand, at least in the past, has always declared a meaningful participation by the emerging economies to be essential in order to agree upon a credible and effective future climate agreement. The challenge for the EU is hence to both get the US and the developing countries on board, making it more difficult also to impose the instrument through which emissions in these countries should be reduced.

### 3.3. Finance for adaptation and technology transfer

Even if the US would take up commitments it is still uncertain whether the emerging economies will take up meaningful greenhouse gas emissions reductions in a post-2012 agreement. An important principle in the climate negotiations is the adherence to “common, but differentiated responsibility”, meaning that those responsible (historically) for the largest share of emissions should be the first to reduce them. Developing countries argue that their per capita emissions are still just a fraction of

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<sup>13</sup> Smith, J. and D. Mix (2007), Transatlantic Climate Change Challenge, in: The Washington Quarterly, 31:1, Winter 2007-2008.

<sup>14</sup> Diringer, E. (2008), The US Election and Prospects for a New Climate Agreement, Pew Center on Global Climate Change, contribution to the Transatlantic Climate Policy Group.

<sup>15</sup> Bodansky, D. (2004), International Climate Efforts Beyond 2012: A Survey of Approaches, Pew Center on Global Climate Change, Arlington, VA (<http://www.pewclimate.org>).

these of the OECD countries and that they still have a long way to go in terms of economic development. On the other hand, it seems more effective and efficient to decouple greenhouse gas emission rise from economic growth in countries where the energy infrastructure is still in its infancy. Technological innovations in such circumstances require other investment patterns and considerable emission cuts will only occur when new technologies spread rapidly. The question is thus which measures would provide the right incentives to trigger such processes without damaging economic growth.

Another important question is to what extent the OECD countries would need to contribute to funding of adaptation activities in developing countries. Within the context of the international climate change negotiations, the importance of assisting developing countries to cope with the effects of climate change, and to provide funds for technology transfer and other means to bring down greenhouse gas emissions, has been acknowledged.<sup>16</sup> It seems logical that acknowledging a responsibility for the climate change problem implies a willingness to pay for its consequences, but it is not as simple as that. The costs incurred by climate change in developing countries may by far exceed the annual amount of Official Development Assistance (ODA) the EU is providing.<sup>17</sup> In total about \$100-200 billion is expected to be needed per year to invest in clean energy, improved energy access, and making development less vulnerable to climate change.<sup>18</sup> Currently available funds, such as those of the Adaptation Fund are of a much smaller magnitude (\$80-300 million per year in the period 2008-2012). Developing countries argue that the resources should not be coming from development aid that was already earmarked to them.<sup>19</sup>

For the EU and other OECD countries it is however difficult to argue domestically why the EU and other countries would have to “pay for building levies” in the more advanced developing countries, where economic growth figures by far exceed that of their own country. The small sums that thus far have been offered give the impression that they are just used to “buy support from the South” for the international climate regime as such.<sup>20</sup> Recent initiatives such as the Global Climate Change Alliance between the European Union and poor developing countries most vulnerable to climate change look promising, but their current funding is not very impressive either. In the light of the current economic crisis it is moreover unrealistic to expect new budget lines for climate change activities in developing

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<sup>16</sup> The Bali Action Plan (2007) calls for “adequate, predictable and sustainable financial resources”.

<sup>17</sup> Klein, R.J.T. and A. Persson (2008), *Financing Adaptation to Climate Change: Issues and Priorities*, European Climate Platform Report No. 8, October.

<sup>18</sup> UNFCCC (2007), *Investment and Financial Flows to Address Climate Change*, United Nations Framework Convention on Climate Change Secretariat, Bonn; Kok et al. (2008), Integrating development and climate policies: national and international benefits, in: *Climate Policy*, vol 8, no. 2, pp. 103-118.

<sup>19</sup> Kartha, S., Bhandari, P., Van Schaik, L., Cornland, D. and B. Kjellén (2006), *Adaptation as a Strategic Issue in the Climate Negotiations*, Report by the European Climate Platform.

<sup>20</sup> idem

countries to become in place, in addition to already committed ODA funds. For EU Member States it already presents a challenge to meet their ODA commitment.<sup>21</sup>

### 3.4. Other issues

Other issues include how to treat forestry, and how to include emissions from international aviation and maritime in an international climate regime. On forestry the EU is willing to be more ambitious than the Kyoto regime currently allows, but it wants to avoid developing countries to be eligible to sell large amounts of “emission reduction” credits, just because they avoid deforestation to occur. Instead, the EU suggests to finance activities to combat deforestation, but whether it will really be able to offer sufficient funds to that regard remains to be seen.

Including emissions from aviation and maritime in the international post-Kyoto regime is extremely important for the EU, but it has encountered great difficulties to obtain any support for this within the relevant international organisations for international aviation and maritime questions, the ICAO and IMO. It tries to include the sectors within the context of the UNFCCC negotiations, but thus far it has not been successful.

## 4. EU CLIMATE DIPLOMACY

The EU’s performance in the international climate change negotiations will depend to a large extent on its domestic performance as will be discussed below. It will also be influenced by its ability to stay united vis-à-vis its negotiating partners. Its ability to be convincing to others hinges upon its ability to speak with a single voice, to be coherent, strategic and skilful in international negotiations. This is related to how the EU organises itself.

Whereas policies to achieve greenhouse gas reduction are generally decided upon through the normal Community method, the decision-making on the mandate for the international climate change negotiations is more intergovernmental. There is a more substantial role for the Council and a smaller role for the European Parliament and European Commission.

The EU position, which de facto could be considered a negotiating mandate, is written down in Council Conclusions and more recently in the Presidency Conclusions (European Council), as well as in EU submissions and statements. The position is usually drafted by the Presidency of the EU Council, which is held by one of the EU Member States on a six-monthly rotating basis. At the UN Climate Summit in Copenhagen, Sweden will be the EU Presidency. The EU position is decided upon

<sup>21</sup> Cf. Van Schaik, L.G. and N. Maes (2008), Bilateral and EU Development Cooperation: Delivering More and Better Aid, Clingendael Seminar Overview paper.

in the Council. This usually happens by consensus reflecting the Member States' individual competence to negotiate in international bodies and to conclude international agreements on environmental issues.<sup>22</sup> It has been argued that the position could also be adopted by means of qualified majority voting. In any event, the final version of an international climate change agreement would need to be signed and ratified by both the European Community and all the Member States.

Within the EU Council, climate change is the prerogative of the Environment Ministers, but the issue is also being discussed within the European Council. Preparatory work is done mainly by the Council Working Party on International Environmental Issues (WPIEI, Climate Change formation). The WP IEI is composed mainly of senior officials from Environment Ministries and DG Environment.

During the international climate change negotiations, there are (Environment) Council meetings on location, the so-called 'EU coordination' meetings. In these meetings, which take place on a daily basis, the climate delegations of the Member States and the European Commission meet at senior official or ministerial level. They decide how to adjust the EU position to reach agreement with negotiating partners. EU coordination takes a considerable amount of time, but generally helps the EU to firmly unite around an issue. The internal discussions also tend to strengthen the EU's argumentative capacity. The Presidency of the EU Council is officially in charge of EU coordination and the external representation. Its representative speaks on behalf of the EC and the EU Member States and is in its tasks assisted by the subsequent, or incoming Presidency, the European Commission and the Council Secretariat. In combination this group is referred to as the troika.

Because the formal workload for the Council Presidency has at times been overwhelming, and because it was deemed important to ensure continuity in the negotiations, other Member States in the past have assisted or taken over parts of the external representation. Since 2004 a more formalised system is in place in which the EU appoints "issue leaders" and "lead negotiators".<sup>23</sup> These are senior officials from Member States and the Commission who cover a specific issue for a longer term. Under the auspices of the Presidency they take care of most of the negotiations at the working level. There is for instance a lead negotiator for the mitigation and one for the adaptation agenda.

The EU's strategy stretches beyond the negotiations conducted within the context of the United Nations Framework Convention on Climate Change (UNFCCC). Due to strong support by the European Commission and several EU Member States, climate change has been included in a wide range of bilateral meetings and featured on the

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<sup>22</sup> The legal basis is Art. 174:4 of the Environment chapter of the EC Treaty. It refers to Art. 300 (EC Treaty), which states that with regard to Community policies it is the Commission that will be authorised by the Council to negotiate international agreements with third countries. The last sentence of Art. 174:4 stipulates however that "the previous subparagraph shall be without prejudice to Member States' competence to negotiate in international bodies and to conclude international agreements".

<sup>23</sup> Cf. Oberthür, S. and C. Roche Kelly (2008), EU leadership in International Climate Policy: Achievements and Challenges, in: *The International Spectator*, Vol. 43, No. 3., September, pp. 35-50.

agenda of several international organisation (e.g. World Bank, UN General Assembly, UN Security Council, UN Development Programme, G-8, World Health Organisation, etc). Climate change and (renewable) energy have become more important topics within the EU's development cooperation activities, European Neighbourhood Policy and Bilateral Agreements. Thereby, climate change increasingly is included in the overall framework of EU external relations, where it is almost as important as trade and security relations. This is reinforced and stimulated by the Green Diplomacy network that consists of diplomats working at the foreign ministries of Member States. Although other external policies thus far have been remarkably coherent with the EU's climate agenda, this should not be taken for granted. It clearly is the result of the strong backing climate change has received at the highest political levels. In fact, the strongly segmented decision-making structures in the Council, is no good recipe for coherence.<sup>24</sup> Clashes of interests between the EU's trade, development cooperation, agriculture, foreign politics and climate change agenda have already occurred in the past and can be expected to reoccur in the future.

That the relationship with foreign policy has become more important is also demonstrated by the increased attention devoted to the relationship between climate change and security. The 2008 Solana paper on the issue is the best proof of this.<sup>25</sup> It followed *inter alia* a study by former US generals.<sup>26</sup> By the end of 2008 Solana is expected to come with a more specific follow-up paper.

Hence, climate change has increasingly entered the realm of high politics and transcended from being merely an environmental issue into an important EU foreign policy issue. In the international negotiations for the time being the Environment Minister of the country holding the rotating Presidency is still in the lead, but it remains to be seen whether this will continue to be the case in the future. With more climate policies being adopted internally in the EU, the Commission may claim authority over external representation in line with earlier rulings of the European Court of Justice on the parallelism of internal and external EC competence.<sup>27</sup> It is furthermore an interesting question whether the EU foreign policy coordinator that is foreseen in the Lisbon Treaty and his or her External Action Service would seek an interest in taking over external representation. This would depend on the extent to which the EU's position in the climate negotiations is termed foreign politics or environmental policy-making. If the Lisbon treaty would enter into force, also the European Parliament may become more involved. Its current advisory role would change to that of giving assent to any international agreement decided upon. It may use this veto position to demand a more prominent role vis-à-vis the content of the

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<sup>24</sup> Cf. CEPS (2006), *Policy Coherence for Development in the EU Council*, paperback.

<sup>25</sup> *Climate change and international security*, Paper from the High Representative and the European Commission to the European Council, 14 March 2008, S113/08.

<sup>26</sup> US generals paper on climate and security. National security and the threat of climate change (2007), CNA Corporation.

<sup>27</sup> Cf. F. Hoffmeister, Outsider or Frontrunner? Recent Developments under International and European Law on the Status of the European Union in International Organizations and Treaty Bodies, *Common Market Law Review*, 2007, 44: 41-68.

EU's negotiating position and may demand more information on how the EU conducts its external representation.

Persisting EU unity and leadership in the climate negotiations is not automatic. It remains a challenge to reach consensus among the 27 Member States and particularly the new Member States would be less ambitious.<sup>28</sup> The EU's performance is moreover still to a large extent dependent upon the rotating Presidency. There are some doubts with regard to whether the EU, and particularly the delegates from Environment Ministries, will be flexible enough to adjust to design choices preferred by the US and developing countries, and are not too much attached to the Kyoto Protocol framework.

Regardless of how the EU's external machinery will operate, an important question will remain how the EU's domestic policies will evolve. The EU's international position is critically dependent upon its internal ability to reduce emissions at low cost. Its ability to lead by example is related to what it has achieved thus far and probably even more by its ability to adopt successfully the recently adopted climate action and renewable energy package.

## 5. THE EU'S CARBON MARKET AND ITS INTERNATIONAL LINKS

Mainly due to a switch from coal to gas in the UK and a restructuring of the economy in former Eastern Germany, the EU-15 thus far did manage to lower its emissions in comparison to 1990 levels, but it is not yet sure whether the effects of the current policies will be sufficient to reach the -8 % reduction target which has been pledged by 2008-2012.<sup>29</sup> Member States may have to accelerate their own policy efforts, as well as consider to expand buying emission reduction credits at the international carbon market. The Member States that joined in 2004 and 2007 are also likely to meet their emission reduction targets, since they are still recovering from a restructuring of their economic activities in the early 1990 which led to a rather drastic reduction of their emissions. It is not yet clear how the economic downturn that is expected for the coming years could affect emissions. What is clear is that current policies will not be enough to achieve the much larger cuts the EU is aiming for in 2020, and hence that new policies both at the European and national level will have to be adopted (some Member States, such as the UK, Germany and the Netherlands, have already adopted ambitious national reduction objectives).

Domestic EU climate measures are clearly connected to the international climate change regime. This section will focus on the EU's most important policy instrument for reducing emissions, the emission trading scheme, and briefly the contentious

<sup>28</sup> Oberthür, S. and C. Roche Kelly (2008), EU leadership in International Climate Policy: Achievements and Challenges, in: *The International Spectator*, Vol. 43, No. 3., September, pp. 35-50.

<sup>29</sup> European Environment Agency (2008), *Greenhouse gas emission trends and projections in Europe 2008*, EEA Report No 5/2008.

issue of including aviation into this scheme. The focus is on the international implications of the scheme. It is realised that there are also many other policies that affect emissions such as the energy performance of buildings directive, land use, renewable energy and energy efficiency policies.<sup>30</sup>

## 5.1. The EU Emission Trading Scheme

Since 2005 the Emission Trading Scheme (EU ETS) is up and running in the European Union. The scheme is designed to help Member States achieve their greenhouse gas (GHG) reduction commitments<sup>31</sup> in a cost-effective way. It is the largest in the world and covers more than 12 000 industrial sites in the 27 Member States that are responsible for almost half of carbon dioxide emissions in the EU. The first trading phase covered the period 2005 - 2007 whilst the second trading phase has begun on 1 January 2008 and will run until the end of 2012 (it thereby coincides with the commitment period of the Kyoto Protocol).

The origins of the EU ETS demonstrate the strong link between the EU's domestic climate policy and the international regime. During the negotiations of the Protocol, European countries reacted reluctantly towards the concept of trading greenhouse gas emissions. Unlike the United States, most European countries did not have any experience with any cap and trade regime. In order to prepare the Member States for international emissions trading by 2008, as foreseen by the Kyoto Protocol, the European Commission wanted to gain practical experience with emissions trading.<sup>32</sup> More importantly was that it proved politically not possible to agree upon a carbon tax to reduce emissions. A reason was that fiscal measures have to be adopted by unanimity. The emissions trading scheme could be adopted through the co-decision procedure with qualified decision-making as decision-making rule in the Council. It was also the most favoured policy instrument for regulating carbon emissions by the private sector. As a result, a Community-wide emissions trading scheme covering European companies could be agreed upon within the EU in 2003 and entered into force in 2005.

The EU ETS gradually developed into a mature system. It became operational before the entry into force of the Kyoto Protocol and functions independently of it. Today, it constitutes the flagship of the EU's climate policy. Moreover, there is some sort of boomerang effect in the sense that experiences with the EU ETS have external effects. Indeed, the EU ETS serves as a model for other emission trading schemes in

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<sup>30</sup> Cf. a good overview of existing policies: Oberthür, S. and C. Roche Kelly (2008), EU leadership in International Climate Policy: Achievements and Challenges, in: *The International Spectator*, Vol. 43, No. 3., September, pp. 35-50; or the European Commission's document *Progress Towards Achieving the Kyoto Objectives*.

<sup>31</sup> The respective commitments of the countries Member States are determined as follows. The so-called burden-sharing agreement redistributes the EU's Kyoto target of 8% among the 15 old Member States. Of the new EU countries, most are subject to individual -8% Kyoto targets, except Poland and Hungary which both have a Kyoto target of -6% and Malta and Cyprus which do not have any Kyoto target.

<sup>32</sup> European Commission, *Green Paper on greenhouse gas trading*, 2000.

the world and as the nucleus for a potential international carbon market under the post 2012 international climate regime. In other words, the EU ETS has developed from the mere domestic EU application of one of Kyoto's flexible mechanisms to a self-standing climate policy instrument which provides a dress rehearsal for a global system.

## 5.2. The link with the Kyoto Protocol's flexible mechanisms

The ETS is not only historically linked with the international climate regime, there is also an important regulatory link between the scheme and the project-based flexible mechanisms (Clean Development Mechanism and Joint Implementation) under the Kyoto Protocol. Thanks to the so-called Linking Directive<sup>33</sup>, companies covered by the ETS have to a certain extent<sup>34</sup> the possibility to use credits generated by emission-saving projects carried out in third countries under the CDM and JI to cover their emissions. This way, domestic EU reduction targets are directly coupled to support for climate change activities in developing countries.

The linkage implies that private actors in the EU directly participate in the international climate regime. More importantly, European companies not merely participate in this regime, they are largely responsible for its development. Figures show that in 2007 EU companies were the most active buyers on the CDM and JI market, with 79% of volume transacted.<sup>35</sup> The prospect that European companies may use up to 1 392 million CDM and JI credits in the second ETS phase (2008-2012) - which represents more than half of the potential global demand for these credits - has been a major driver for the explosive growth of CDM projects in developing countries (mainly India and China).

However, the strong link between emissions trading in the EU ETS and the flexible mechanisms is quite ambiguous. There are several doubts about the environmental integrity and the efficiency of the CDM.<sup>36</sup> Many CDM projects have failed to generate additional GHG reductions in developing countries which implies that, instead of reducing emissions at home, European companies are financing emission-reduction projects that would have been carried out anyway, because they reduce costs of

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<sup>33</sup> Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004, amending Directive 2003/87/EC establishing a scheme for greenhouse gas emissions allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms, *OJ*, L 338, 13 November 2004, p. 18.

<sup>34</sup> The use of CDM and JI credits by EU companies is limited, both quantitatively and qualitatively. Each Member State must specify in its national allocation plan (NAP) the maximum extent to which companies on its territory may use JI or CDM credits. This limit is expressed as a percentage of the allocation of allowances to each installation. As far as the qualitative limitation is concerned, the link between ETS and the flexible mechanisms does not allow for the conversion of credits from nuclear facilities or from land-use, land use change and forestry activities ("sinks").

<sup>35</sup> *State and Trends of the Carbon Market 2008*

<sup>36</sup> See M. W. Wara and D. G. Victor, *A Realistic Policy on International Carbon Off sets*, PESD Working Paper, No. 74, April 2008; L. Schneider, *Is the CDM fulfilling its environmental and sustainable objectives? An evaluation of the CDM and options for improvement*, Report prepared for WWF, Öko-Institut, 5 November 2007.

production. There are furthermore complaints about CDM activities being concentrated in China and other emerging economies. Too few projects would be established in the least developed countries. On a more strategic level the CDM poses the question of how emissions reductions from CDM projects compare to reductions following from government policies. Could domestic policies interfere with opportunities for CDM project and could in this respect the CDM constitute a barrier for new policies to be put in place? Yet others argue the CDM should be scaled up to such an extent that it goes beyond projects and could in the future lead to sector-based activities financed by richer countries through which developing countries can reduce their emissions. In this context, some observers have argued for a fundamental reform of the CDM and possibly to decouple the ETS from the CDM.<sup>37</sup>

### 5.3. The prototype for an international carbon market

The ETS has become a landmark in international climate change policy. It has become the reference for a much larger international emissions trading scheme. As mentioned above, the scheme serves as a model for other emission trading schemes in the world. Article 25 of the ETS Directive indeed provides the possibility of linking the ETS with other (national or regional) greenhouse gas emissions trading schemes.

A number of countries are developing or are considering domestic emission trading schemes. Schemes are emerging in the US, Australia and Canada (albeit at state level), and various developing countries have expressed interest in the use of emissions trading. This could lead to the emergence of a truly international carbon market. Such an international market, connecting the various schemes to each other, is one of the key issues in the negotiations on a post-2012 international climate change regime. The ETS, the largest and most important scheme at the moment, could constitute the central pillar of this international carbon market.

In November 2006, the European Commission issued a Communication highlighting the Commission's commitment to the development of a global carbon market, as an instrument for tackling climate change. As mentioned above, in October 2007, the European Council stressed that a global carbon market is fundamental to encourage low-carbon investments and underlined the importance of linking the emission trading schemes.

In this context, the International Carbon Action Partnership (ICAP) was set up in 2007. ICAP is a partnership between the European Commission, a number of EU Member States, US States, Canadian provinces, New Zealand and Norway. It intends to become a forum in which governments and public authorities that are engaged in

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<sup>37</sup> See J. Henningsen, EU energy and climate policy - two years on, EPC Issue Paper no. 55, September 2008, pp. 16-18.

the process of designing or implementing carbon markets can share experiences and discuss relevant questions on the design, compatibility and potential linkage of carbon markets. This way, ICAP should contribute to the establishment of a well-functioning global carbon market.

There are various options to link the EU ETS with other schemes. It could happen in a direct way, in the sense that entities are allowed to purchase and use allowances from another trading scheme for domestic compliance obligations, or indirectly, whereby schemes A and B are linked to the EU ETS but not to each other. As for the legal form, linking could be established through a binding international treaty - which is the preferable method - or through bilateral agreements. The prospect of the ETS as the foundation of a global emission market naturally raises the question which role the EU, and in particular, the European Commission, should play in a linked system. There are two possible scenarios: either the EU ETS forms some sort of hub from which links emanate to other schemes, or a network of schemes exist with links between various schemes. In the latter case the EU's primary role would be probably less clear and the UNFCCC could instead manage the system.

In theory, linking the various schemes to each other makes sense from an economic and environmental point of view. It would reduce overall compliance costs and reduce the market volatility of prices. In practice, however, it is clear that connecting the schemes to each other will be a considerable legal and technical challenge, with the biggest risk being the incompatibility of the designs of the respective schemes. As previously mentioned it also remains difficult to see how the ETS could be linked with systems in countries who do not want to commit at international level to a legally binding emissions reduction target, which would logically set the longer-term cap for emission reductions.

#### **5.4. The inclusion of aviation in the EU ETS**

The impact of aviation on climate change is increasing. The aviation industry is considered the fastest growing source of carbon dioxide emissions in Europe. Between 1990 and 2004, emissions in Europe rose by a staggering 87%. By 2020, aviation is expected to contribute around one fifth to the EU's climate impact.<sup>38</sup> In order to reverse this trend, the European Commission adopted in December 2006 a proposal to integrate aviation in the EU ETS. In June 2008 the European Parliament and the Council reached an agreement on the Commission's proposal, endorsing its key elements. The Council gave formal approval to the directive in October 2008.<sup>39</sup>

Following the newly adopted rule both internal EU flights (with departure and arrival inside the EU) and external flights (with departure or arrival outside the EU)

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<sup>38</sup> "Inclusion of aviation emissions in the EU Emissions Trading Scheme", Workshop on the European Commission's proposal to include aviation into the EU Emissions Trading Scheme (ETS), 7 June 2007, p. 1.

<sup>39</sup> Council press release 14664/08, "Council gives green light for inclusion of aviation into the EU Emissions Trading System", available from

[http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/misc/103533.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/misc/103533.pdf)

will be covered by the trading scheme. However, the proposal foresees that when a third country adopts measures to address the climate impact of aviation, the Commission has the possibility to exclude flights arriving from that country from the scope of application of the scheme.

The imposition of the ETS on non-EU carriers threatens to invoke political repercussions. All non-EU countries that are members of the International Civil Aviation Organization (ICAO), the UN body that regulates international aviation, have expressed their opposition to the proposal on legal<sup>40</sup> and policy grounds. In September 2007, the ICAO's General Assembly adopted a resolution that would make it compulsory for countries implementing market-based measures, such as emissions trading, to first obtain the agreement of each third party operating in their airspace.<sup>41</sup> The EU, however, registered a formal reservation to the resolution, stating that it will not feel bound by it.<sup>42</sup>

Meanwhile, the United States described the inclusion of aviation in the EU ETS as unlawful and unhelpful<sup>43</sup>. Washington has even threatened that any unilateral moves forward by the EU may lead to retaliation with trade sanctions. In this respect, the already troubled transatlantic relationship in terms of aviation - remember the WTO-dispute between Boeing and Airbus - may further deteriorate. More importantly, it risks jeopardising the ongoing negotiations on the second stage of the EU-US "Open Skies" Agreement.<sup>44</sup>

## 6. THE CLIMATE ACTION AND RENEWABLE ENERGY PACKAGE

In March 2007, the European Council agreed on the ambitious 20-20-20 objectives. EU heads of state and government made an independent commitment to reduce GHG emissions by 20 % below 1990 levels by 2020. This percentage would be automatically increased to a 30 % reduction in the case of an international climate change agreement. In addition, the Council agreed to increase the share of

<sup>40</sup> The question whether the EU has the competence under international law to include non-EU flights in the ETS is the subject of a debate in the literature. See M. Petersen, "The Legality of the EU's Stand-Alone Approach to the Climate Impact of Aviation: The Express Role Given to the ICAO by the Kyoto Protocol", *Review of European Community & International Environmental Law*, Volume 17, Issue 2, August 2008, pp. 196 - 204.

<sup>41</sup> ICAO resolution A36-22, Consolidated statement of continuing ICAO policies and practices related to environmental protection, Appendix L, 28 September 2007.

<sup>42</sup> Written statement of reservation on behalf of the Member States of the European Community (EC) and the other states members of the European Civil Aviation (ECAC) [made at the 36th Assembly of the International Civil Aviation Organization in Montreal, 18-28 September 2007], MEMO/07/391, 2 October 2007.

<sup>43</sup> "Aviation Emissions Best Tackled Through Cooperation", *Innovation*, USINFO, 3 August 2007.

<sup>44</sup> The first EU-US Air Transport Agreement was signed on 30 April 2007. The agreement is essentially an "open skies" type of agreement, enabling European airlines to fly without restrictions from any point in the EU to any point in the US. The agreement also foresees closer cooperation between the US and the EU on environmental matters. Negotiations on a second-stage agreement, which could further liberalise mutual access to both markets, have commenced in May 2008.

renewable energy in the EU final energy consumption to 20 % and to raise energy efficiency by 20 %.

In January 2008 the European Commission presented the long-awaited 'climate action and renewable energy package', a number of legislative proposals that, once approved, will form the first step towards implementation of the ambitious 20-20-20 goals. The proposed package includes a revision of the emission trading scheme<sup>45</sup> (EU ETS), a directive on renewable energy<sup>46</sup>, a decision on effort sharing in the non-ETS sectors<sup>47</sup>, a directive on carbon capture and storage<sup>48</sup> as well as revised environmental state aid guidelines<sup>49</sup>.

The climate package is closely linked to the outcome of the negotiations on an international climate change agreement for the post-2012 period. In line with the overall GHG reduction target, several key elements of the Commission proposals are made dependent on whether or not a future international climate agreement is achieved. In addition, the package contains various design choices with relevance for the international climate change negotiations.

### 6.1. A change of baseline year

A first element is the introduction by the proposals of 2005 as the baseline for emission reductions. The choice for 2005 is justified, because it is the first year for which reliable data were available from the sectors covered by the emissions trading scheme. A similar argument goes for the international negotiations, where the 1990 base year that was used for the Kyoto Protocol is unlikely to persist, as there are no reliable 1990 data for many developing countries. But the choice for 2005 may also be seen as a gesture towards the US, whose emissions have increased tremendously compared to 1990 levels and who may hence have a preference for using 2005 as a baseline.

Within the EU the choice for 2005 as a baseline is contested by a number of new EU Member States who prefer earlier years when their emissions were still considerably lower. Their argument is opposed by a number of other Member States who consider the package as proposed by the Commission is balanced and provides sufficient mechanisms that demonstrate solidarity with less-wealthy Member States. At the time of writing it is unclear how this discussion will end. What is clear however is that the choice of baseline year is a sensitive and strategic issue, which will most

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<sup>45</sup> Proposal for a Directive amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community, COM(2008)16.

<sup>46</sup> Proposal for a Directive on the promotion of the use of energy from renewable sources, COM(2008)19

<sup>47</sup> Proposal for a Decision on the effort of Member States to reduce their greenhouse gas emissions to meet the Community's greenhouse gas emission reduction commitments up to 2020, COM(2008)17.

<sup>48</sup> Proposal for a Directive on the geological storage of carbon dioxide and amending Council Directives 85/337/EEC, 96/61/EC, Directives 2000/60/EC, 2001/80/EC, 2004/35/EC, 2006/12/EC and Regulation (EC) No 1013/2006, COM(2008)18

<sup>49</sup> Community Guidelines on State Aid for Environmental Protection...

likely also be the case in the international negotiations. Adjusting the baseline and/or target year in which emission reduction commitments have to be achieved is a method through which positions of states can be modified without the significance of this becoming clear to everyone immediately (e.g. it is not immediately clear how a minus 35% reduction in the period 2004-2034 compares to a -45% reduction in the period 1995-2035). Perhaps this is the reason why the EU in its most recent Council Conclusions advocates the importance of a clear reference to 1990 as the base year in accordance with the findings of the IPCC.<sup>50</sup>

## 6.2. GDP per capita as distribution key

A second element relates to the usage of relative GDP per capita as the criterion for differentiating reduction efforts between countries. Under the package, the sectors which are not covered by the ETS (primarily transport, buildings, services, small industrial installations, agriculture and waste) have to reduce their greenhouse gas emissions by 10% in comparison with 2005. This overall 10% target is divided among the 27 Member States on the basis of their respective GDP per capita with a boundary ranging from -20% to +20%. This should ensure that the reduction efforts and associated costs are distributed in a fair and equitable manner and allow for further economic growth in less wealthy Member States. In other words, it is the translation within the EU of the common but differentiated approach, one of the key principles of the international climate regime.

The use of a GDP per capita index to differentiate between countries in the same manner as it is proposed between the EU Member States could be a strong trigger for support of the newly industrialised countries for the future international agreement. It would provide India and China, who are traditionally reluctant to stringent reduction commitments, with quite some scope for emission increases. Although these countries strongly increase their emissions, their per capita emissions remain much lower than industrialised countries. Even on the basis of the present trends, the per capita emissions of China and India will only reach respectively two-thirds and one-fifth of those of the OECD countries in 2030.

Some however argue against using GDP/ capita as a means to distribute emission reduction commitments. They argue it is more cost-effective to avoid emissions in countries where the energy infrastructure is not yet as much developed as in the OECD countries. Others wonder how we could possibly reach the reduction levels advocated by the IPCC scientific evidence when China and India do not reduce their absolute emissions, or at least make their economic growth trajectory less greenhouse gas intensive.

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<sup>50</sup> Council Conclusions on the preparations for the 14<sup>th</sup> session of the Conference of the Parties (COP 14) to the United Nations Framework Convention on Climate Change (UNFCCC) and the 4<sup>th</sup> session of the Meeting of the Parties to the Kyoto Protocol (CMP 4) (Poznań, 1-12 December 2008), 2898<sup>th</sup> Environment Council meeting, Luxembourg, 20 October.

This is the reason why countries, such as the US, Japan, Australia, Russia, Canada and the OPEC countries, cannot be expected to support a distribution of GHG emission reductions fully on the basis of GDP/capita levels. Also the EU itself wants advanced developing countries like China and India to “contribute adequately” to emission reductions, thereby implicitly rejecting the idea of distributing the burden in such a way that emissions could still increase in the poorer countries.

Another options would be a division on the basis of GHG emissions per capita, but here similar issues as the ones outlined above come to the fore. The EU however seems more keen on this solution. In its most recent Council Conclusions it argues “that, by 2050, global average greenhouse gas emissions per capita should be reduced to around two tonnes CO<sub>2</sub> equivalent, and that in the long term, gradual convergence of national per capita greenhouse gas emissions between developed and developing countries would be necessary”.<sup>51</sup>

### 6.3. Expanded use of project-based mechanisms in developing countries

A third element in the package is the forecast of an increased use of CDM credits within the ETS in case an international agreement is signed. The Commission's proposal to reform the ETS allows companies to continue the use CDM and JI credits after 2012 but the extent of this possibility explicitly depends upon the existence of a satisfactory international climate treaty. This is a clear signal to the developing countries that the EU is willing to offer a large potential for buying up a lot of CDM credits. It thus serves as a strong negotiation element for the EU in the current post-Kyoto discussions.

The proposal makes a distinction between various scenarios.

- In case no international agreement were reached, JI and CDM credits can be used in the third trading period up to the import limit of the second phase<sup>52</sup>, but no new JI and CDM credits would be allowed. In other words, operators will be able to use credits given to them by their governments for the period 2008-2012 that they have not already used up.
- However, if an international agreement would be reached, the limit on the use of JI/CDM credits would be automatically increased up to half of the additional reduction effort. This means that if the annual cap under the EU ETS were reduced by e.g. 200 million tonnes following a global agreement (in order to achieve the more stringent 30% reduction target), the limit on the use of JI/CDM credits would be raised automatically by 100 million credits. (monetary values)

<sup>51</sup> Council Conclusion October 2008.

<sup>52</sup> Under the conditions for the second trading period, around 1400 Mt of credits are allowed to enter the ETS, or a yearly average of 280 Mt.

- Furthermore, in the event that the conclusion of an international agreement is delayed, credits from projects or other emission reducing activities may be used in the Community scheme in accordance with bilateral agreements concluded with third countries, specifying levels of use. Moreover, only CDM credits from third countries which have ratified the new agreement will be accepted in the ETS.

The European Commission's proposal has already lead to uncertainty on the CDM and JI markets. According to the World Bank, the European Commission's proposal has "the risk, surely unintended, of slowing the momentum for the project-based mechanisms". It is also not clear how it squares with the more fundamental discussion on reform of the CDM. It is for instance not clear what will happen with the availability of credits when projects would be restricted in China, India and Brazil.

#### 6.4. Trade measures

A fourth element is the introduction of the possibility for the installation of a 'carbon equalisation system'. Should the post-Kyoto negotiations fail to lead to a deal, the Commission reserves itself the right to identify by June 2011 which energy intensive sectors are likely to be subject to carbon leakage, i.e. the relocation to third countries with less stringent climate change policies. Energy-intensive industries which are found to be exposed to a significant risk of carbon leakage could not only receive up to 100% of their allowances for free, an effective carbon equalisation system could be introduced in order to neutralise the distorting effects from third-country imports. Such a system could for instance consist in applying a border tax adjustment to importers of the products concerned in the ETS.

The possibility of a carbon equalisation system is not only an answer to the fears of European industry and social partners, it also aims at deterring (industrialised) countries that are reluctant to commit to GHG emission reduction commitments in an international regime. The Commission indeed leaves a substantial time gap for those countries to commit themselves after the 2009 Copenhagen conference.

The potential establishment of a EU carbon tax adjustment mechanism - principally advocated by France - has brought the relationship between the EU climate change policy and international trade rules to the forefront. Although the Commission has explicitly stated that any action should be in conformity with these rules, there is an ongoing debate on the risk of legal interference with the WTO framework. It also risks leading to considerable pressure on the trade relationship between the EU and third countries. From this perspective, it is worth recalling that Susan Schwab, the US trade representative, has already warned the EU that its unilateral climate legislation might provoke retaliation.<sup>53</sup>

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<sup>53</sup> Beattie, Alan, Green barricade: Trade faces new test as carbon taxes go global. Financial Times, 23 January 2008.

## 6.5. Generating funds for climate change activities in developing countries

A fifth and final element relates to the allocation method of allowances in the reformed ETS. Following the controversy around free allocation in the first two trading phases<sup>54</sup>, the Commission proposes to make auctioning the principal allocation method in the third trading period. Under the proposal, at least 20% of the revenues from auctioning - which are estimated at around 50 billion EUR per year - should be earmarked for climate change activities.<sup>55</sup> The revenues should not only be used for financing intra-EU activities (such as carbon capture and storage), but also for climate-related actions in developing countries, notably for "measures to avoid deforestation, in particular in Least Developed Countries and to facilitate developing countries' adaptation to the impacts of climate change".<sup>56</sup> The ring-fencing of the auction revenues, however, is the subject of a political battle as most Member States wish to maintain flexibility over the generated revenues.

For aviation it has already been decided that a percentage of auction revenues could be allocated to climate change related activities in developing countries. But, also for this issue the most recent Council Conclusions on the EU's position for the international negotiations "recall that it is for the Member States to determine, in accordance with their constitutional and budgetary provisions, how the revenues generated by the auctioning, from 2012 onwards, of 15 % of the EU ETS allowances for aviation are to be used, and that in this context, they undertake to combat climate change in the EU and third countries, inter alia to reduce greenhouse gas emissions, to adapt to the impacts of climate change, especially in developing countries, and to fund measures to avoid deforestation".

It is understandable that Member States want to retain fiscal sovereignty, but in the light of the crisis on the financial markets and expected economic downturn, it is difficult to see where the considerable funds that are likely to be needed to convince India and China to join a post-2012 climate agreement, will come from. Let alone, that these funds are likely to be needed to ensure considerable reductions and changes to the energy infrastructure will actually materialise. For OECD governments, it already proves difficult to reach pledged increases of Official Development Aid funds. Seen from this perspective it would perhaps be better when (parts of the) future auctioning revenues would never become national income, but flow into an international fund directly. In that respect the 2 % levy on CDM transactions flowing automatically into the Adaptation Fund provides an interesting example.

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<sup>54</sup> In the first periods, allowances were allocated for free to businesses. This has widely been recognised as one of the major flaws in the current design of the scheme.

<sup>55</sup> In its vote on 7 October, the Environment Committee of the European Parliament even indicated that 50 % of the auction revenues should be used to finance climate change activities in non-EU countries that have ratified the future international climate change agreement.

<sup>56</sup> Article 10(3) of the proposed Directive.

## 6.6. Uncertainties

The five above-mentioned elements can be considered as signals to negotiation partners to join the EU's commitment to combating climate change. As such, the package grants the EU a strong mandate for the post-Kyoto negotiations. Many questions remain however. How will the automatic scaling up of the 20 percent GHG reduction target to a 30 percent target take place in practice? Which institution is to decide whether the international agreement, if any, will be satisfactory? Will the European Parliament have a say in this? What if certain of the large GHG emitting countries do not participate? And, what will remain of the EU's ambitions in a worst-case-scenario in which no post-Kyoto agreement is reached?

Even when the proposals will be adopted successfully achieving its objectives, particularly the effort sharing targets, will depend on the implementation by Member States. The increase in renewable energy that is foreseen will not be sufficient to reach the greenhouse gas reductions that are required. Considerable energy efficiency improvements will be quintessential and these have proved the most difficult to adopt and implement in the past.<sup>57</sup> In order to avoid distortions of the internal market EU Member States will to a large extent be dependent upon new and strengthened EU regulations. An example is the proposed regulation to reduce emissions from cars, which has become subject to fierce negotiations which to a large extent have diluted the original ambitions for sharp reductions. Member States may also want restore to the use of subsidies to stimulate investments into low carbon technologies. Whether they can reach their target in a cost-effective way will also to a large extent depend on factors more difficult to influence with (EU) government policies, such as technological breakthroughs and the price of oil.

## 6.7. No time to waste

The climate and energy package is certainly the most important political European dossier of the last months. The proposed measures will, once adopted, have a tremendous impact on each Member State's environment, energy structure, industry and economy in general. The economic crisis has reinforced the impact of the package. It is therefore no surprise that each country wants to safeguard its national interests.

The French government has made the adoption of the package the highest political priority of its EU Presidency. It has the difficult task of trying to find an agreement between the Member States on the one hand and between the Council and the Parliament on the other hand before the end of 2008. The present economic context has further complicated the already troubled discussions as more and more claims are made to soften the proposed climate measures and to better protect European industry. As such, several key elements of the proposals, such as the auctioning of emission allowances to the energy sector, are being questioned by Member States

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<sup>57</sup> J. Henningsen (2008), EU energy and climate policy - two years on, EPC Issue Paper no. 55, September.

and political groups. At the time of writing of this paper, it was impossible to predict the outcome of these negotiations.

The final decision on the package would ideally have to be taken at the next meeting of European leaders on 11-12 December - a timing which coincides with the closure of the international climate conference in Poznan. In any case, an agreement should be found in early 2009 at the latest, given that in June 2009 European Parliament elections will take place and in the autumn of 2009 a new college of EU Commissioners is expected to commence work.

Agreeing on the package is not only of vital importance for the EU's credibility towards its citizens, it will also determine to a large extent the EU's capacity to mobilise and influence its negotiation partners in the run-up to a post-Kyoto treaty. Any failure to come to an agreement on the package would fundamentally undermine the EU's negotiation position in the international talks. From this perspective, the intra-EU negotiations, particularly on the effort-sharing, are an important test-case for the international post-Kyoto negotiations. It will show whether and how the EU manages to reconcile countries with diverse economic backgrounds and different perceptions of the climate change problem in the current economic context. Given that these differences are even more explicit on a global scale, one can wonder how on earth a world-wide compromise would be possible in case the European countries cannot find an agreement among themselves.

## 7. CONCLUSION

EU climate policy is perhaps the only EU policy in which the internal and external dimensions are so fundamentally and clearly intertwined. There is an intrinsic link between the domestic EU policy and the international climate regime, both from a regulatory and a diplomatic point of view. In regulatory terms the link between the ETS and the Kyoto Protocol flexible mechanisms stands out. In terms of diplomacy, the use of the climate action and renewable energy package as a negotiation tool in the current negotiations, and its linkage to possible trade measures in case other countries will not follow the EU's emission reduction ambitions draw attention.

To a certain extent the interwovenness between internal and external climate policies should not surprise. Anthropogenic climate change is caused by greenhouse gas emissions emitted anywhere on earth and therefore the global level seems also to be the most appropriate to decide upon emission reductions. Without international backing EU policies will not make the difference, despite them also having other advantages such as diminishing fossil fuel related costs and security questions. It is praiseworthy that the EU seeks to strengthen its global leadership on climate policy through domestic EU policies, but is dangerous at the same time. Leading by example is only possible when the EU succeeds in adopting the climate action and renewable energy package and further contingent upon its successful implementation. When Copenhagen would not lead to a convincing outcome - which

is not unlikely given that the Summit may come too early for the US - the EU's policies may come under pressure.

Although it is realised that climate change no longer is a soft policy issue, the way the EU decides upon its position and organises its external representation, makes it a relatively inflexible negotiator whose leadership changes every half a year. Such a system may not hold in case it is seriously challenged. Although the EU has provided strong leadership in the past decade, current negotiations may require a more robust and diplomatic approach. Above all, the EU will have to prove its own ability to adopt the climate action and renewable energy package, as the world is watching.

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- Notes -



## About the EGMONT Institute

The Royal Institute for International Relations, EGMONT (former IRRI-KIIB), founded in 1947 by eminent Belgian political leaders, is an independent think-tank based in Brussels. Its interdisciplinary research is conducted in a spirit of total academic freedom. A platform of quality information, a forum for debate and analysis, a melting pot of ideas in the field of international politics, the Institute's ambition - through its publications, colloquia, seminars and recommendations - is to make a useful contribution to the decision-making process.

Drawing on the expertise of its own research fellows, as well as that of external specialists, both Belgian and foreign, it provides analysis and suggests international policy options that are meant to be as operational as possible through our three programmes: **European Affairs, Security & Global Governance, and Central Africa.**

Along with research and meetings, the Institute has also developed **specialised training activities**, both in Brussels and abroad. It can, on request, offer specific programmes for visiting and resident diplomats and foreign professionals.

## About the European Affairs Programme

The "European Affairs" Programme started its work in 1995. It has been in charge of drafting studies, syntheses, proposals and amendments at the request of the Federal Public Service Foreign Affairs, Foreign Trade and Development Cooperation as well as other ministries, in the context of several European negotiations. Since 1995, it has been associated with the negotiations preparing the Amsterdam Treaty, Agenda 2000, the Nice Treaty and the activities of the European Convention. It has contributed in many ways to the Belgian presidency of the European Union in 2001.

Research studies are published either in "Studia Diplomatica" or as Egmont Papers or Working Papers series on our website, thus giving our readers access to structured information about current matters. Certain issues are also the object of conferences and seminars. Such activities respond to the wish to initiate as broad a discussion as possible on the future of Europe.

EGMONT - European Affairs Program's Main Areas of Research are : Internal policies of the EU ; Justice, Liberty and Security ; External dimension of the EU ; and Institutional matters.

EGMONT - European Affairs Program's Current Research Projects are : Treaty Reform and European Institutions ; Towards a new Energy Policy for Europe ; New perspectives for Climate Change ; The EU - Russia Partnership ; and Budget Reform and Common Agricultural Policy.

## Publications

- 📄 Studia Diplomatica 2008, Vol. LXI: The Climate Change Challenge: International, European and Belgian Aspects.
- 📄 The Coming Energy Crash and its Impact on the European Union, Franklin Dehousse, Egmont Paper, n° 17, Feb. 2008.
- 📄 The Kyoto Policy of Belgium, Karel Van Hecke and Tania Zgajewski, Egmont Paper, n° 18, Feb. 2008.
- 📄 Studia Diplomatica 2007, Vol. LX: 2007: Towards a real European Energy Policy?

## Events

- **03 Dec. 2008:** "The CAP and the other European policies: Peculiarities and Convergences" - Expert Seminar organised by EGMONT & Notre Europe.
- **12-13 Nov. 2008:** "Belgo-British Conference: Natural Resources: challenges and opportunities", organized by EGMONT and the British Council.
- **12 Sept. 2008:** "Climate Change as a Factor of Peace" organized by EGMONT, and Embassy of Costa Rica with the collaboration of CERIS.

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