New rules, new politics, same actors – explaining policy change in the EU ETS

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New Rules, New Politics, Same Actors—
Explaining Policy Change in the EU ETS

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Abstract: The allocation rules for phase one EU ETS emissions permits demonstrates that energy generators were lobbying winners because they successfully blocked differential treatment (rules) from energy intensive industries, who cannot pass-on real or nominal costs of permits to consumers. As a result, these generators benefited from windfall profits. In phase three, the reverse is true; energy intensive industries successfully established differential rules. These rules will provide energy intensive industries with free allocations while most generators will be subject to 100 per cent auctioning, thus removing the windfall profit mechanism for generators. Literature applying public choice theory to this case study predicted free permit allocations but not windfall profits for generators nor the change in allocation rules in phase three. This paper presents the argument that a shift in Wilson’s Typology from client to interest group politics best explains these changes and provides a good framework for other jurisdictions considering emissions trading reforms. This dynamism in Wilson’s Typology is demonstrated by comparing the positions of industry associations representing energy generators and energy intensive industries with the two directives before and after consultations, which facilitates the identification of lobbying winners and losers. The EU ETS case study is fertile ground for testing regulatory theories that explain shifts away from clientelist policies with high levels of rent-seeking and towards more optimal policy equilibriums. This paper provides both a theoretical framework and empirical evidence for how emissions trading policy can be improved, despite rent-seeking, once it clears the legislative hurdle.

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PART ONE: INTRODUCTION

Emissions trading (ET) is an important regulatory instrument to address climate change because it is said to be efficient, effective, and equitable. While all three claims are subject to criticism, this paper uses the European Emissions Trading Scheme’s (ETS) regulatory failures as a case study because it is the first of its kind and provides valuable policy lessons for ET programs elsewhere. Specifically, industry lobbying for free European Union Allowances (EUA) in phase one (2005-2007) and phase two (2008-2012) has been criticised for creating windfall profits benefiting electricity generators (generators) and raising electricity prices for both domestic consumers and energy intensive industries (EIs). However, phase three (2013-2020) allocation rules require 100 per cent auctioning for most generators and free permits for some EIs.

Table Two below explains that phases one and two were the product of the same directive and consultation process. Phase one is now complete which provides a rich source of empirical evidence and academic literature. Phase three, however, was subject to a separate directive and consultation process. References to phases one and three throughout this paper also refer to their enabling directives unless otherwise specifically stated.

The puzzle is: what explains the change in permit allocation rules between ETS phases one and three? In particular, as actor preferences have not significantly changed and most private interest theories of regulation predict the static dominance of producer interests at the expense of diffuse cost-bearing publics, why did this shift take place?

This paper will argue that Wilson’s politics of regulation Typology is more applicable to EU policymaking than private interest theories and that, within EU policymaking, a shift has taken place that is consistent with a movement that Wilson would typify as a change from client politics to interest group politics. This Wilsonian shift usefully explains the change in EUA allocation rules between ETS phases one and three.

The ETS is an interesting case study because it demonstrates the possibility of policy shifts that can be captured within the terms of Wilson’s Typology. Such changes, moreover, can be tracked evidentially. The ETS consultation process for phases one and three directives was transparent. All lobbying positions are available on the EU Commission’s (commission) website. EURELECTRIC represented generators in both phases. EIs lobbied mainly individually in phase one, but formed the Alliance of Energy Intensive Industries (AEII) in phase three.

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1 N. Stern, Blueprint for a Safer Planet: How to Manage Climate Change and Create a New Era of Progress and Prosperity (London: The Bodley Head, 2009).
Comparing the positions of these associations with the original commission proposals and final directives in both phases allows, with certain assumptions, for the identification of lobbying winners and losers. The results of this analysis will then be matched with Wilson’s typological descriptions to show that his theory provides a better explanation for the change in allocation rules.

As Wilson predicted greatest rent-seeking with client politics, conclusions will assess the prospects of ETS reflecting optimal policy prescriptions. These conclusions may be of significance to policymakers designing American, Australian, and global ET schemes.

**PART TWO: UNDERSTANDING ALLOCATIONS**

Relatively few scholars have applied private interest theories to ET schemes, and even fewer have used Wilson’s Typology. The literature also struggles to explain changes in allocation rules between phases. Although some scholars apply Wilson’s Typology to analyse American SO2 trading and ETS phase one, to date none have applied Wilson’s Typology to phase three’s final EUA allocation; instead the policy change between ETS phases have been explained using EU policymaking theories not Wilson’s more universal typology that considers the distribution of regulatory costs and benefits. Also, while a number of authors have explained free over-allocation of EUAs in phase one, none predicted the windfall profits of generators nor considered potential changes in allocation methods after 2012.

This section will assess the relevance of private interest theories to this topic, particularly their applicability to EU policymaking and their ability to explain

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4 See section ‘What prospects for phase three?’ below.
regulatory change. The case will then be made for using Wilson’s approach instead.

PRIVATE INTEREST THEORIES AND EMISSIONS TRADING

Private interest theories and the policymaking process

Private interest theories all highlight the risks of capture caused by information asymmetry and revolving door career paths. While modern versions of these theories now explain business preference for ET, historically they predicted the dominance of command and control regulation. Both analyses point to potential rent-seeking with either instrument resulting from Hayek’s ‘knowledge problem’ of insurmountable informational asymmetries. More recently, scholars have signalled the importance of market-based instruments (MBI) like carbon taxes or ET to reduce this asymmetry and discourage ‘revolving door’ career paths that contribute to capture. By choosing ET instead of best available technology mandates, or cap and trade systems rather than baseline and credit approaches, asymmetry and the potential for capture is reduced. Despite the theoretical foundations of various private interest approaches, there exists little empirical evidence to support either capture or revolving-door careers. Government failure has also been criticised as a myth.

There are two dominant schools of private interest theories, each with different assumptions about actor motivation. The Chicago school of law and economics believes legislators and regulators seek to maximise their personal wealth. Virginian public choice scholars assume that in addition to financial interests, these actors are motivated by electoral and ideological gains. In both models, regulatees seek to extract rents (excess profits) caused by government intervention in the economy (eg limiting competition by awarding monopolies or creating other barriers to market entry). Despite the strong empirical evidence for private interest theories, they have been criticised for a lack of applicability to EU policymaking and a failure to adequately explain policy change.

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10 n 2 above, 263; n 7 above, 180.
The limits of private interest theories

1. EU policymaking

Foster reveals the challenges of applying Chicagoan and Virginian theories to EU policymaking through his analysis of network industry ownership in Britain.\textsuperscript{14} In rejecting a Chicagoan explanation for nationalisation, he describes the centrality of pork-barrel lobbying to Chicagoan models.\textsuperscript{15} The Chicagoan approach is therefore more applicable to political systems like America with liberal campaign finance laws, weak political parties, and first-past-the-post electoral systems, a combination rarely found in Europe.\textsuperscript{16} Following an intergovernmentalist approach to EU policymaking, member states, and therefore European institutions, are less exposed to Chicagoan arguments.\textsuperscript{17} For example, the EU Parliament (parliament) cannot initiate legislation and is elected by proportional representation, and other EU institutions are not directly elected. Parliament also operates by consensus through transnational groupings and is therefore less exposed to capture in the Chicagoan sense.\textsuperscript{18} This likely explains why parliament has always favoured EU auctioning.\textsuperscript{19}

At first glance, Virginian explanations are more convincing. However, following a supranationalist argument, the commission dominates and is the locus for most lobbying activity, although the plurality of EU institutions allows lobbyists to venue shop and should not be regarded as monolithic.\textsuperscript{20} Nevertheless, the EU policymaking dynamic is different to congressional or parliamentary systems because the powerful commission seeks neither electoral nor ideological gains in the Virginian sense because it is an unelected bureaucracy. The commission is arguably motivated less by ideology than by Brussels empire-building, jurisdictional expansionism, and budget maximisation through regulation.\textsuperscript{21} Authors have highlighted the growth and domination of interest group activity by corporate interests in Brussels and how the commission gives insider status to business and funds groups – non-governmental organisations (NGOs) – that provide informational support for its agenda of European integration.\textsuperscript{22}

\begin{enumerate}
\item ibid, 497.
\item Markussen and Svendsen, n 6 above, 253.
\item Svendsen, ibid, 131; for an illustration of EU policymaking theories that demonstrate this see Skjøsrød and Wettøstad, ibid, 65-93.
\item For example, ibid, 93; Svendsen, n 6 above, 154, where the author posits that centralised policymaking at the commission makes lobbying cheaper than more fragmented polities like America. See, also, C. Mahoney, ‘The Power of Institutions State and Interest Group Activity in the European Union’ (2004)...
provides a severe challenge to private interest theories because it reverses the direction of capture. Part Four will discuss evidence of this in ETS phase three.

2. Explaining policy change

The Chicago school struggles to explain policy change more than other regulatory theories. If regulation is a function of client politics (see Table One), then what explains policy reversals that reduce rents like full EUA auctioning? While Chicagoans such as Peltzman, Keeler, and Noll have argued that endogenous processes of ‘rent dissipation’ cause shifts to deregulation, evidence of this phenomenon is patchy. In addition, no risk of windfall profit dissipation exists for generators because the industry is not exposed to global competition. Virginian theories better explain change because the utility functions of politicians are broader; they are motivated by ideological gains and shifting voter preferences. Therefore, electoral backlashes (against producer dominance) or ‘new ideas’ are endogenous to Virginnian theory and can explain deregulation. While other regulatory theories such as pluralism and institutionalism are important to understand policy dynamism, a discussion of them is beyond the scope of this paper. Instead, the following analysis will consider the dominant literature: public choice application to ETS phase one.

Public choice application to emissions trading

Most literature applies public choice to ETS because it reveals the risks of regulatory failure. Unless planners have sufficient incentives to act on and acquire the necessary information to correct market failures, it is a ‘nirvana fallacy’ to assume that politics can fix markets. Political markets are mired with transaction costs and collective action problems that generate client politics equilibriums. The rational ignorance of voters provides little incentive for monitoring or mobilising

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23 n 16 above, 27.
26 This is strength rather than a weakness in terms of loss of predictive power which Baldwin and Cave argue, n 13 above, 25.
27 Keeler, n 25 above, 130; n 14 above, 501.
30 Pennington, ibid, 17.
against rent-seeking by small, wealthy, organised lobby groups. Politicians and bureaucrats are monopolists in their domains and have strong incentives to make short-term gains through rent distribution and to empire-build with clientelist coalitions. Such has been the strength of rent-seeking in both America and Australia that ET programs have failed to clear legislative hurdles in both countries (see the section on Policy implications below). Indeed, America has abandoned the more efficient economy-wide cap and trade program in favour of a sectoral approach, with ET primarily for electric utilities; and even the legislative success of this proposal is uncertain.

Public choice literature defines the self-interests of large emitters (large electricity generators, EII), politicians, environmental NGOs (ENGOs), and bureaucrats in a consistent way. Generally speaking, large emitters are profit maximisers with goals to minimise climate policy costs and/or gain additional rents. This explains their preference for ET compared to carbon taxes. Within this group, large electricity producers in Europe and America favour grandfathered permits. Elected politicians (parliament and council) are assumed to be risk-averse opportunists with a primary objective of re-election. ENGOs have historically focused on targets and not policy instruments because they raise funds through easily understandable campaigns. However, significant literature exists analysing the preference and opposition of ENGOs to MBIs and ET in particular. Bureaucrats (commission) prefer instruments that allow discretionary decisions, require negotiation and are based on special information needs. This allows them to empire-build by budget-raising, to link climate policy with other growth areas, and to play a central role in implementation. It also demonstrates a bias towards the conservatism of command and control regulation.

Markussen and Svenden identified winners and

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34 n 2 above, 264.
36 Boom, n 6 above, 220.
37 n 18 above, 158.
39 n 18 above, 156; Svendsen, n 20 above, 107.
40 Boom, n 6 above, 235.
losers for Directive one, while Wettestad did so for Commission Proposal Two (see Table Two for details of these documents).

With these interests in mind, public choice theory has made a number of predictions that have been confirmed by empirical evidence to explain why ET is counterproductive and deviates from economic prescriptions. For example, public choice predicts that the preferences of small, powerful, cohesive industry lobbies will be reflected in permit allocation rules (free grandfathering) and abatement levels (lower). Empirically, the American SO2 trading scheme and the ETS evidenced this phenomenon. At an international level, business preferences are reflected in the Kyoto Protocol Joint Implementation and Clean Development Mechanism. The large gap between the ambition of international agreements and the reality of domestic implementation can also be explained by the relatively greater strength of climate protection interests at the international level. Finally, the divergence between mandatory ET legislation in Europe and America or Australia can be partly explained by the commission’s self-interest in institutionalising the ETS.

While these failures cannot be disputed, ETS phase three is an improvement on phase one. Public choice struggles to explain this phenomenon because actor preferences have not significantly changed (see Case Study Analysis below). The commission always favoured auctioning, and industry always preferred free permits. Even while EII objected to generator windfall profits they favoured free allocation for themselves and demanded compensation for higher energy prices. EURELECTRIC also begrudgingly accepted auctioning in phase three (see Table Six in Appendix One). Wilson’s Typology and derived literature provide a better

\[\text{\footnotesize 41 Markussen and Svendsen, n 6 above; Wettestad, n 5 above; see also Skjoerseth and Wettestad, n 5 above, 65-93, for a discussion of how EU theories explain allocation rule changes in the ETS.}\]


\[\text{\footnotesize 45 n 18 above; Falkner, ibid; A. Michałowa ‘Climate Policy and Interest Groups-A Public Choice Analysis’ (1998) November/December Interconomics 251.}\]

analytical framework for explaining different allocation rules. This last discussion
will complete the literature review.

WILSON’S TYPOLOGY

Wilson’s Typology is a political rather than economic explanation for regulation. It
complements public choice theory by providing a profile for successful rent-
seeking groups instead of simply assuming regulation is demanded and obtained.\(^47\)
Wilson’s theory does not explain how benefits materialise because unlike
Virgini ans and Chicagoans, Wilson ignores the consideration for regulatory
bargains.\(^48\) The Typology therefore suffers from a critique of generality, but is also
more applicable to EU policymaking. The essence of Wilson’s argument is that the
distribution of regulatory costs and benefits is central to predicting rent-seeking
levels. Wilson’s Typology also provides roles for policy entrepreneurs, force of
ideas, and other political explanations for regulatory change, because costs and
benefits are not exclusively monetary. The importance of economic interests
differs throughout Wilson’s theory.\(^49\)

Wilson’s Typology describes four politics of regulation. When benefits of
regulation are concentrated and costs are dispersed, client politics (the Chicag oan
original sin) emerges with very high levels of rent-seeking because cost-bearers
face high barriers to collective action due to group size.\(^50\) The general public (often
cost-bearers) may not be aware of clientelist regulation because negotiations are
usually opaque. However, NGOs are now important checks on this phenomenon.

Less favourable conditions for rent-seeking are expected in the following
three circumstances. Firstly, when costs and benefits of regulation are
concentrated, interest group politics emerges, meaning that regulation will benefit
one group at the expense of another. Each side has an incentive to organise and
exercise political influence with less rent-seeking resulting. While the public may
sympathise with one group over another, its voice only is heard in general terms.
In the second circumstance, costs and benefits are both dispersed, and all or most
of society expects to both gain and pay. As such, both opponents and proponents
of regulation may find it difficult to organise. A majoritarian politics will therefore
emerge only when popular sentiment and elite opinions are convinced of
regulatory benefits. Lastly, entrepreneurial politics occurs when the benefits of
regulation are dispersed but the costs are concentrated. In this situation,
opponents have strong incentives to block regulation. Yet even Wilson observed
how policy entrepreneurs can mobilise latent public support despite collective
action challenges. Table One illustrates Wilson’s Typology with examples.\(^51\)

\(^47\) n 16 above, 24; n 13 above, 24.
\(^48\) Noll, n 25 above, 1277.
\(^49\) n 3 above, 361-372.
\(^50\) Olson, n 31 above.
\(^51\) n 3 above, 365-372.
Table One: Wilson's typology – the politics of regulation\textsuperscript{52}

<table>
<thead>
<tr>
<th>Benefits of Regulation</th>
<th>Costs of Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Concentrated</strong></td>
<td><strong>Dispersed</strong></td>
</tr>
<tr>
<td>Interest Group Politics</td>
<td>Client Politics</td>
</tr>
<tr>
<td>Example: rail freight rate regulation</td>
<td>Example: restrictions on imports</td>
</tr>
<tr>
<td>Entrepeneurial Politics</td>
<td>Majoritarian Politics</td>
</tr>
<tr>
<td>Example: restrictions on tobacco sales</td>
<td>Example: public smoking bans</td>
</tr>
</tbody>
</table>

**Wilson's typology and emissions trading**

To the author's knowledge, only three articles analyse EM regimes with Wilson’s Typology and none compare changes between ETS phases one and three.\textsuperscript{53} Joskow and Shmalensee concluded that free allocations in the American SO\textsubscript{2} trading scheme generated majoritarian politics because costs and benefits were widely distributed instead of weighted toward narrow economic or geographical interests.\textsuperscript{54} A majoritarian equilibrium is synonymous with climate policy goals which: (1) internalise carbon costs so that they are borne by all carbon-intensive consumers; and (2) spread the benefits of climate stability widely. Patashnick draws the same conclusions to theorise why such general interest reforms are sustained.\textsuperscript{55} However, both these analyses overlook how ET works in practice; some firms profited by passing-on costs while others could not. Cook’s working paper instead characterises the SO\textsubscript{2} trading program as interest group politics because the final legislation pleased each affected party.\textsuperscript{56} His analysis also finds evidence of interest group politics in ETS phase one because industries received free EUAs and competed for both exclusion and lower abatement targets. However, Cook does not address the issue of generator windfall profits in phase one, nor does his analysis extend to phase three which requires full auctioning for generators and free permits for most EII.\textsuperscript{57} Part Four below explains how these omissions are important counter-arguments to Cook’s characterisation of phase

\textsuperscript{52} Source: Adapted from Hood, n 16 above, 25.
\textsuperscript{53} See n 5 above.
\textsuperscript{54} n 5 above, 70, 81.
\textsuperscript{55} E.M. Patashnik, Reforms at Risk: What Happens After Major Policy Changes are Enacted (Princeton: Princeton University Press, 2008) 153-154. General interest reforms are defined by Patashnik on page 2 as ‘non-incremental change of an existing line of policymaking intended to rationalize governmental undertakings or to distribute benefits to some broad constituency’. Therefore Patashnik’s conception is very similar to Wilson’s entrepreneurial and majoritarian politics.
\textsuperscript{56} n 5 above, 13.
\textsuperscript{57} ibid, 16.
one. This supports the paper’s hypothesis that phase one was an example of client not interest group politics.

*Explaining regulatory change using Wilson’s typology*

Wilson’s Typology adds to existing ETS public choice literature because it better explains changes across phases. By recasting Svendsen and Cook’s work in terms of client politics and analysing recent scholarship by Wetttestad, Skjoerseth and Gullberg, who use EU theories to demonstrate that EHS won in phase three, valuable insights can be gained.58 This paper will apply Wilson’s Typology to both final ETS directives to explain different EUA allocation rules.

Wilson provides little explanation for shifts in his typology except for the possibility of entrepreneurial politics. He believes policy entrepreneurs are facilitated by crises and by the discovery of electoral ore from regulation that benefits scattered groups at the expense of narrow ones.59 Keeler, Bendor, and Moe make this argument to explain deregulation.60 However, Wilson is unclear as to whether entrepreneurial politics means blank slate regulation (new) or changes to regulation formed in client or interest politics equilibriums to reflect a new alignment of costs and benefits. His rather static view of cost-benefit distribution suggests the former, and therefore Wilson does not explain how regulation escapes the iron grip of client politics.

A small but fascinating body of scholarship develops Wilson’s Typology to explain these changes; some of which was canvassed above (see Explaining policy change). Hood divides the literature between exogenous (force of ideas) and endogenous (interest group) explanations, although as discussed above, ideas are not necessarily exogenous to Wilson’s model. For example, the very prescriptive success of Chicagoan theories may have undermined their descriptive accuracy through exogenous new ideas (regulatory failure) which facilitated shifts from client to entrepreneurial politics.61 Adding to Peltzman and Keeler’s endogenous arguments analysed above, Hood describes a ‘lose-to-win’ strategy adopted by AT&T in accepting deregulation for access to new markets.62 Also, counter-mobilisation occurred when corporate consumers lobbied for deregulation of telecommunications markets to lower costs and compete with other financial centres. However, Hood explains that counter-mobilisation cuts both ways and

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58 Svendsen, n 20 above; Svendsen n 6 above; ibid; Wetttestad, n 5 above; Skjoerseth and Wetttestad, n 5 above, 65-93; A.T. Gullberg, ‘The European Electricity Sector and the EU ETS Review’ (CICERO Working Paper 2008:01, Oslo: Center for International Climate and Environmental Research, 2008).
62 n 25 above; n 16 above, 30.
can cause a shift back from entrepreneurial to client politics.\textsuperscript{63} The tendency of client politics to self-destruct may also explain shifts to interest group equilibriums, although very little literature explores this point. The case study analysis in Part Four below explores this self-destructive pattern in the ETS.

New scholarship provides explanations for the rise and sustainability of general interest reforms.\textsuperscript{64} Patashnik surveys the literature and outlines three conditions for adoption: (1) policy entrepreneurs must lower information costs to mass publics by linking reform solutions to salient issues (eg by linking ET to GHG mitigation policy); (2) reform proponents must adopt procedural strategies to weaken the organisational advantages of narrow groups (eg by developing expert knowledge or changing committees structures); and lastly (3) reform advocates must use tactical concessions to neutralise political opposition (eg by providing free permits).\textsuperscript{65} Patashnik then argues that general interest reforms are most resilient when they upset coalitional patterns and stimulate the emergence of new vested interests and political alliances. This last point is significant because one of the advantages of ET compared to carbon taxes is that the former is easier to implement politically because policymakers can pay-off opponents and create new political constituencies that have a stake in ET programs.\textsuperscript{66} However, somewhat paradoxically, this virtue can be a vice if rent-seeking is so strong that stakeholders lose faith in ET, resulting in a failure to implement in the first place. This phenomenon is currently being observed in both America and Australia.

In light of the literature, this paper addresses the following puzzle: what explains the different EUA allocation rules for generators and EII between ETS phases one and three? The proposed and tested hypothesis is: a shift can be seen in Wilson’s Typology, as one from client politics to interest group politics. This shift explains the change in allocation rules.

\textbf{PART THREE: A SHORT HISTORY OF THE EU ETS}

The ETS is the cornerstone of EU climate policy. Launched in 2005, it is the first cross-border greenhouse gas emissions (GHG) trading scheme and regulates more than 11,500 installations or about 45 per cent of total EU CO$_2$ emissions.\textsuperscript{57} Phase one ran from 2005 to 2007, while phase two runs from 2008-2012. The EU directive (\textit{Directive One}) that enabled both these phases fell under the co-decision

\textsuperscript{63} n 16 above, 33.
\textsuperscript{64} See n 55 above.
\textsuperscript{65} ibid, ch 2.
\textsuperscript{66} ibid, 144; J.P. Voß, ‘Innovation Processes in Governance: The Development of ‘Emissions Trading’ as a New Policy Instrument’ (2008) 34(5) \textit{Science and Public Policy} 329, 338; n 2 above. For example, carbon markets create a powerful and rapidly growing set of vested financial interests with strong incentives to lobby for the continuation of the ETS. Also, ring-fencing auctioning revenues for renewable energy projects create new political constituencies.
\textsuperscript{67} Egenhofer, n 46 above, 453.
mechanism and entered into force on 13 October 2003. It was legislated after the Council of Ministers (council) unanimously modified Commission Directive One, along with a very large majority in parliament.

*Directive One* was the result of rigorous commission consultations with stakeholders. The *Green Paper* provided the reference for this. In only a few cases did the commission express explicit preferences (see Table Six below in Appendix One). The commission’s main preference, as expressed in the *Green Paper*, was for a centralized allocation process to provide a level playing field between countries. It also appears that the commission preferred auctioning as a method of EUA allocation. However, after critical responses from industry and Member States, such as Germany and the U.K., Commission Directive One proposed a free decentralized EUA allocation process which was incorporated into Directive One.

Phase three of the ETS (2013-2020) was triggered by Directive One Article 30 which required that the commission submit a report to parliament and council before extending the directive after the Kyoto Protocol expires (phase three: 2013-2020). The report assessed ETS performance and concluded the need for a review. This gave rise to a number of position papers and studies by stakeholders with further consultations within the European Climate Change Program (ECCP). The ECCP established a working group on the review and produced final reports incorporated into a commission communication. Membership of the working group was comprised of member states, industry, NGOs, academia, and research institutes. These consultations formed the basis of a second commission directive (*Commission Directive Two*). It was modified into Directive Two, which was adopted unanimously by the council with only 60 votes against and 29 abstentions in parliament. Directive Two entered into force on 5 June 2009. Table Two provides a legislative timeline.

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72 ibid.
Table Two: EU ETS legislative history

<table>
<thead>
<tr>
<th>Phase one</th>
<th>Green Paper (2000)</th>
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<tbody>
<tr>
<td>(2005-2007)</td>
<td>Green Paper Consultation (2000)(^{75})</td>
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<tr>
<td></td>
<td>Commission Report Consultations (2007)(^{77})</td>
</tr>
<tr>
<td>Phase three</td>
<td>Directive Two (2009)</td>
</tr>
<tr>
<td>(2013-2020)</td>
<td></td>
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</tbody>
</table>

The main features of Directive One and Directive Two is briefly summarized as follows and are listed in Tables Six and Seven (Appendix One). Directive One proposes a decentralized system, where Member States play a critical role in deciding the amount and allocation of EUAs and the commission acts as watchdog to ensure compliance with agreed upon allocation criteria. The EU regional cap is therefore the sum of all national caps. EUAs are primarily handed out for free and the scope of sectors and GHGs covered is narrow. Directive One also allows credits to be imported from third countries through Kyoto’s Clean Development Mechanism. Directive Two, on the other hand, is much more centralized. It has done away with national allocation plans and introduced more GHGs and sectors. Most importantly, it has adopted auctioning of EUAs as the general principle from which exceptions are made. Restrictive rules on importing credits from third countries are also incorporated.

Multiple purposes prevent labelling ETS phase one an overall regulatory failure. ETS phase one was a trial period with a goal to ensure European leadership promoting global cost-effective climate policy instruments.\(^{78}\) This leadership component has been accomplished; however, a complete regulatory success would


have resulted in the absence of both windfall profits and over-allocation.\textsuperscript{79} This is significant because ETS phase three will not require 100 per cent EUA auctioning. The potential for regulatory failure still exists. As a result, many commentators propose a carbon tax as an alternative policy tool because it is less susceptible to rent-seeking and provides price stability.\textsuperscript{80} The next section presents the evidence to identify winners and losers in both ETS phases.

\textbf{EVIDENCE ANALYSED}

The industries analysed are limited to large electricity generators and EIIIs. It is clear from the literature review that generators on balance won in phase one, while EIIIs won in phase three.\textsuperscript{81} This paper seeks to explain the reasons for this change. The positions of individual firms and NGOs are also not analysed.\textsuperscript{82} Instead, the interests of large generators are reflected in EURELECTRIC’s positions. The AEII represented 12 energy intensive industrial sectors (most EIIIs) in phase three but not phase one. A full list is found in Appendix Two. The AEII was created after the relative failure of its members’ lobbying and previous weaker umbrella groups’ efforts (UNICE, IFIEC) in phase one.

The lobbying positions of EURELECTRIC and the AEII in phases one and three are represented in Tables Four and Five. Table Six compares the Green Paper to Directive One, while Table Seven compares Commission Directive Two to Directive Two. Table Four illustrates the divided positions of EII members during phase one. All tables are found in the appendices.

\textbf{IDENTIFYING WINNERS AND LOSERS}

Adding to the findings of Markussen and Svendsen, Tables Four, Five and Six indicate that phase one did not produce absolute winners despite some sectors faring better than others.\textsuperscript{83} All industrial sectors wanted a voluntary system, which

\textsuperscript{79} See ibid; windfall profits occurred because very little EUA auctioning occurred in ETS phases one and two, and allocations were based on the historical emissions of each installation. Energy generators incorporated the nominal prices of EUAs in their rates despite receiving them for free. Over-allocation resulted because of the decentralised allocation system which provided member states with incentives to protect national industries. Modest emissions targets, data constraints, and the political challenges of forecasting economic growth all contributed to the EUA price crash in 2006. For a detailed analysis of the EU ETS and European electricity markets see: A. D. Ellerman, F.J. Convery and C. De Perthuis, \textit{Pricing Carbon} (Cambridge: Cambridge University Press, 2010) 293-328.


\textsuperscript{81} All interviews; Gullberg, n 58 above; Wettestad, n 5 above; EndsReport ‘Trading Down to a Low-Carbon Economy’ (2009) 408 Ends Report 38.

\textsuperscript{82} BP and Shell were instrumental in institutionalising the ETS because they had significant experience with their own internal emissions trading schemes and provided great informational resources to the commission. The literature review above also mentions the significance of NGOs. See Braun, n 22 above, 13; J.B. Skjårsæth and J. Wettestad, \textit{EU Emissions Trading: Initiation, Decision-Making and Implementation} (Aldershot: Ashgate, 2008) 184.

\textsuperscript{83} Markussen and Svendsen, n 6 above, 253; Skjårsæth and Wettestad, ibid.
Directive One rejected. Only chemical and aluminium industries successfully lobbied for exclusion. They claimed the ETS would affect their ability to compete internationally. Free grandfathered EUAs are an example of cross-sectoral success particularly when compared to auctioning. However, the divisions of AEII members on this issue are glaring. It may explain their inability to oppose allocation and banking decisions left to member states which created the competitiveness problems discussed above in the first section of Part Three. Generators on the other hand favoured national allocations because it allowed consideration (ie lobbying) of national differences in reduction potential, despite their numerous cheap options for CO₂ reductions compared to EIIs. Finally, by avoiding auctioning, generators reaped windfall profits. The fact that EIIs did not identify this issue, promote auctioning for generators, or obtain compensation for higher energy prices is further evidence that generators fared better than most EIIs in phase one. Markussen and Svendsen attribute this success to generators being the largest and most important sector for implementation.

Like phase one, phase three did not produce absolute winners; however, Table Seven demonstrates EURELECTRIC did not receive the lions’ share of concessions. It gained only one important victory in Directive Two – that of optional derogations for generators in Poland and the Baltic. This is limited to a high percentage of fossil fuel generation and interconnectivity with Russian energy alternatives (see Article 10(c) in Table Seven). Despite the apparent coup, it is not attributable to EURELECTRIC’s position. Instead it reflects the unique characteristics of these domestic energy markets and the symbolic goal of political unanimity at the council for Poznan Conference of the Parties (COP) 14. It is a mere ‘fig leaf’ according to one EU insider because the qualifying threshold for derogations is very high.

AEII on the other hand, received every concession except one – that of regulating electricity costs (see Table Seven). However, Directive Two, Article 10(a) allows member states to compensate industries for GHG cost pass-through, with admittedly very strict benchmarks. This is nevertheless an improvement on Commission Proposal Two, which omitted the issue. The AEII also improved Commission Proposal Two by increasing the number of small installations excluded.

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86 n 6 above, 253.
88 Commission interviews.
from the ETS and adding a qualitative criterion to the methodology for identifying industries at risk of carbon leakage.\(^9^0\)

Wettestad and Gullberg both argue that when analysed through the lens of industry differentiation, it is clear that EURELECTRIC won in phase one, and AEIIIs won in phase three.\(^9^0\) By differentiation, Wettestad means electricity generators can pass-on real or nominal costs of EUAs without risk of carbon leakage or displacement, while some EIIs cannot because they are exposed to global competition.\(^9^1\)

The next and final section will attempt to provide a theoretical framework for explaining this change in winners and losers between phases one and three using Wilson’s Typology.

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\(^{89}\) Commission interviews; Directive Two, n 74 above, Art 10(a), (c) and Annex II. Carbon leakage is defined in n 72 above as: ‘relocating of GHG activities from the EU to third countries, thereby increasing global emissions.’ Some Baltic generators are exposed to carbon leakage because of their interconnectivity and competition with Russian energy suppliers. They therefore cannot pass-on nominal or real EUA costs (interview); see also: EndsEurope, ‘Baltic States to Link up with Wider EU Grid’ (18 June 2009) at http://www.endseurope.com/21597?referrer=search (last visited 20 May 2010).

\(^{90}\) n 5 above; n 58 above.

characterize phase one as client politics by analyzing the reasons for why interest group politics did not emerge immediately when it had the potential to do so. This will be done by proposing a broader understanding of regulatory costs and benefits to include: transaction, informational, agency and collective action costs and benefits.

On balance, evidence for phase one fits with Wilson’s description of client politics. Small, well-organised generators successfully secured free EUAs and passed-on their nominal costs to diffused domestic consumers, generating significant windfall profits. However, two facts do not neatly fit this model: (1) allocation rules were transparently devised; and (2) powerful EII could have ensured the emergence of interest group politics. Wilson envisaged client politics as one of ‘backstairs intrigue, quiet lobbying, and quick passage with a minimum public discussion’.92 This was not the case for the ETS legislative process. Also, public interest arguments about climate change mitigation are the reason for these directives, which Wilson believed would require ‘more elaborate justifications— and thereby mobilize a more extensive coalition’.93 The other three politics envisage greater transparency or at least some public knowledge of the rents being lobbied for. This is because majoritarian politics require public support for adoption, while entrepreneurial politics require policy entrepreneurs to mobilise latent public sentiment. Interest group politics expect a lukewarm public whose voices are heard in ‘weak or general terms’.94 Consequently, while the case study evidence prevents any serious characterisation of phase one as either majoritarian or entrepreneurial politics, it does present the following question: why did interest group politics not emerge in the first place?

As discussed in Part Two, Cook has characterised phase one as interest group politics.95 He concludes that evidence of interest group competition fits Wilson’s prediction because something in the ‘final legislation please[d] each affected party’.96 However, resulting windfall profits for generators do not fit with lower rent-seeking expectations of interest group politics, nor does the fact that eventual EII regulatory costs are borne by all carbon-intensive consumers (not just EII as the concentrated costs of interest group politics suggests). Rather, these facts fit with client politics. Also, if interest group politics emerged in phase one, why did the allocation rules change in phase three? This form of politics expects only marginal changes due to fierce competition.

There are at least three important factors that help explain why interest group politics did not emerge in phase one: (1) the windfall profit mechanism was not widely understood or made transparent by generators; (2) EII were divided and not well-organised; and (3) the legislative process was rushed with steep learning curves for most involved. Each of these factors will be discussed in turn.

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92 n 3 above, 369.
93 Ibid, 370.
94 Ibid, 368.
95 n 5 above, 16-17.
96 n 3 above, 368.
Ellerman and Joskow argue that ‘the effects of the ETS on wholesale and retail power prices and generator profitability when the sector was being liberalized were not widely understood’.97 This is supported by the fact that no reference to potential windfall profits exists in the very comprehensive Green Paper.98 On the other hand, greater profitability for low-carbon generators (nuclear, hydro) in liberalised markets was expected because wholesale market prices reflect EUA values. However, these installations received few or no permits.99

In addition, not everyone at the commission understood the risk of windfall profits. The DG Enterprise and Industry, whose stakeholders are the EII’s, remained unaware of this risk until late in the negotiation process. Only through piecing together evidence about price interaction with marginal power plants did EII’s become aware of windfall profits risks.100 Individual interviews suggest that in hindsight, ‘the commission was naïve to not recognize why EURELECTRIC supported the ETS’.101 On the other hand, the DG Environment was ‘probably aware’ as an official there argues that:

windfall profits were understood from a textbook perspective only. The commission did not understand how it worked in practice. For example, which firms are price makers or takers and how it would equalize across sectors or how liberalization would put a downward pressure on this phenomenon […] competitiveness was the most important issue for lobbyists in phase one, not windfall profits.102

The DG Energy and Transport was most aware of this risk, because their stakeholders are the generators, but all interviewees persist that requiring higher auctioning levels for generators ‘was part of the compromise required for implementation’.103

Generators likely understood they would benefit from windfall profits. EURELECTRIC carried out ET simulations in 1999 and 2000 where its members presumably learned about windfall profits.104 An official at EDF confirms this and acknowledges that generators anticipated windfall profits.105 However, another official at the same company argues that ‘free allocations were introduced primarily to minimize the competitiveness impacts on coal rather than nuclear generators’.106

97 n 78 above, 27.
98 n 70 above, s 7.3.
99 Egenhofer, n 46 above, 457.
100 Commission interviews.
101 ibid.
102 ibid.
103 ibid.
104 Braun, n 22 above, 13.
105 Industry interview.
106 ibid.
EII s were not well-organised in phase one. Markussen and Svendsen draw this conclusion as do Engenhofer and Wettestad.\(^{107}\) Wettestad argues that ‘they woke up and got their ETS act together’ after phase one, becoming more knowledgeable, united and improving their standing within the commission.\(^{108}\) This is evidenced by their role in establishing and dominating the High Level Group\(^{109}\), their active participation in the ECCP\(^{110}\) meetings, and their multi-targeted lobbying drive in phase three.\(^{111}\) All three activities ensured the impossibility of ignoring windfall profits and carbon leakage. In contrast, during phase one ECCP meetings, EII s were uncoordinated and partly disagreed amongst themselves. One observer likened it to ‘having slept in class’.\(^{112}\) This conclusion is also strengthened by the inability of EII s to speak with a single voice in Tables Four and Five and the frequency of \(\Delta EII\) press releases after Directive One was legislated (more than 10 were issued after January 2004 and none before that date).

ETS phase one was a quick policy-making process guided by the principle of implementability where groups with knowledge and experience with ET had stronger lobbying power. After the withdrawal of America from the Kyoto Protocol in 2001, the commission embarked on a learning, consultation, and implementation sprint to establish the ETS in four years. This was part of its strategy to replace America as climate change policy leader.\(^{114}\) Phase one ECCP meetings were dominated by generators because they provided the commission with information on how ET worked.\(^{115}\) Officials interviewed at the commission all posit that phase one was a trial period; the most important goal was to get things


\(^{108}\) Wettestad, n 5 above; industry interviews. For example, the EEF commissioned an independent study on the effects of carbon leakage for the British steel industry.

\(^{109}\) The High Level Group on Competitiveness, Energy and the Environment was established in 2006 as a follow-up to the October 2005 communication on Industrial Policy, see Commission (EC), ‘Implementing the Community Lisbon Programme: A Policy Framework to Strengthen EU Manufacturing: Towards a More Integrated Approach for Industrial Policy’ (Communication) COM (2005) 474 final, 5 October 2005. It consists of member state representatives and various bodies representing industrial energy producers and consumers, and ENGOs. Wettestad, n 5 above, 314, and Gullberg, n 38 above, 3, both argue the group was dominated by energy intensive industries.

\(^{110}\) This group was the primary institution for stakeholder input in ETS phases one and three. In phase three, EII s outnumbered generators for ECCP membership by three to one; they also became important sources of information to the commission, particularly regarding the impact of electricity and carbon prices on competitiveness and how to calculate firms at significant risk of carbon leakage. See Wettestad, ibid, 311-313.

\(^{111}\) Corporate Europe Observatory, ‘Watering Down the EU’s Climate Policies a Multi-Pronged Corporate Attack’ (December 2008) at http://archive.corporateeurope.org/docs/climatelobby2008.pdf (last visited 20 May 2010); Wettestad, n 5 above, 317; EndsReport, n 81 above.

\(^{112}\) Wettestad, ibid, 315.

\(^{113}\) See press releases in Appendix Two below.


\(^{115}\) Braun, n 22 above, 12.
started because it triggers a learning process and institutionalises the regime. Avoiding the American fate, where business blocked mandatory carbon regulation, was high on policymakers’ minds.\textsuperscript{116} Confronting lobby groups on allocation methods risked closing the commission’s implementation window. It also would have detracted from the herculean tasks of technical forecasting and data collection necessary for market creation and to negotiate National Allocation Plans.\textsuperscript{117}

The core of Wilson’s argument is that the distribution of costs and benefits of regulation explains levels of rent-seeking. While ETS phase one had all the characteristics of being an example of an interest group battle, it appears from this case study that costs and benefits do not operate in a vacuum. They need to be transparently understood, and interest groups also need time to mobilise. In this sense, there are informational costs and transaction costs to collective action that provide certain interest groups with lobbying advantages. These costs can be significant and explain why Wilson’s Typology, in its simplest form, does not always match the empirical reality. Nevertheless, this insight fits with Wilson’s typology if regulatory costs and benefits are conceived of more broadly to include: transaction, informational, agency, and collective action costs and benefits. Moreover, this ETS case study illustrates how the transactions costs and collective action problems which characterize political markets (particularly for disparate consumers) also need to be considered for the \textit{prima facie} wealthy, sophisticated and powerful.

In summary, ETS phase one evidenced very strong characteristics of client politics, particularly when Wilson’s conception of regulatory costs and benefits are viewed broadly to understand the dynamics of collective action, transaction and informational costs that gave generators a lobbying and rent-seeking advantage over EII’s. The next section will make the case that phase three corresponds with Wilson’s description of interest group politics.

\section*{EXPLAINING SHIFTS: CAN REGULATORY FAILURES BE CORRECTED?}

ETS phase three can be characterised as interest group politics because the final legislation pleased each affected party and resulted from competition between active and knowledgeable interest groups that did not face asymmetries in collective action and information costs.\textsuperscript{118} For instance, EURELECTRIC remained very active but understood windfall profits would end after phase two although it did not endorse auctioning. Instead, its achieved message was that other sectors should not unduly benefit from free allocations.\textsuperscript{119} As in phase one, the process was transparent, but this time public opinion clearly sided with EII’s (who were

\textsuperscript{116} Layzer, n 46 above, 105.
\textsuperscript{118} Industry interview.
\textsuperscript{119} Commission and industry interviews.
better organized, on message and well positioned to influence the commission) because global competition risks and public outrage over higher energy prices, with corresponding profits, received headlines. The level of overall rent-seeking in phase three matches interest group politics expectations: auctioning removes windfall profits for generators, and the exceptions for facilities in Eastern Europe expire in 2020 and use strict benchmarks, while the free-allocations for EIIIs also characterized by restrictive benchmarks and review clauses.

At present, the impacts of ET policies are understood by broad constituencies, and the first signs of a major shift to entrepreneurial or majoritarian politics are appearing. The allocation rules are moving towards optimal policy prescriptions which disperse both costs and benefits of regulation by requiring 100 per cent auctioning for all sectors by 2027 (Wilson’s majoritarian politics). As such, all consumers pay the final costs, and no industry unduly benefits. Nevertheless, this majoritarian equilibrium is taking an entrepreneurial route because, depending on which EIIIs qualify for free EUAs in phase three and beyond, some may bear the complete cost of regulation while all dispersed consumers may benefit from lower emissions. The ETS will eventually become majoritarian. However, this prospect is likely longer-term because full carbon-cost internalisation (with costs born fully by carbon-intensive consumers) is only expected if and when carbon targets tighten through 2020 and beyond. Also, future generations (not current cost-bearers) will benefit from climate stability if targets are overshot.

Other than the greater organisation, cohesion, and resources of EIIIs, ETS case study facts in phase three match the theoretical explanations for shifts away from client politics surveyed in the literature review (see Part Two above). For example, exogenous shifts in the form of global competition raised the profile of carbon leakage facing EIIIs. Indeed, Wetttestad argues that windfall profits on their own did not justify different allocation rules between industries. Rather, it was the combination with fears of carbon leakage that facilitated regulatory change. In addition, the importance of auctioning as a policy instrument to remove windfall profits may have operated as a ‘force of idea’. Elements of client politics’ tendency for self-destruction are also visible because high-profile windfall profits and resulting higher electricity prices were bound to create a public backlash.

The ETS case study matches Patashnick’s three conditions for policy reform. The first condition, that policy entrepreneurs lower information costs, was present in the form of NGOs, EIIIs, and the media, who explained the link between prices and windfall profits; while consumers also painfully felt the impact of higher

121 n 1 above, 26.
122 eg AEII press releases in Appendix Two below.
123 n 5 above, 317.
124 Commission (EC), ‘Question and Answers on the Commission’s Proposal to Revise the EU Emissions Trading Scheme’ (Memorandum) MEMO/08/35, 23 January 2008; n 78 above, 30; n 24 above, 5.
electricity prices.\textsuperscript{125} The second condition, procedural strategies to weaken vested interests, existed as new working groups were created with greater weight given to EIs. Finally, the third condition of tactical concessions is seen in the commission’s strategy to neutralise ET opposition. In phase one, it secured the support of the largest emitting group, through free permit allocations. In phase three, it developed formulas to allocate free EUAs to EIs and to compensate them for higher energy costs. Generators may have also adopted a lose-to-win approach by accepting auctioning because they will pass-on EUA costs to consumers and can potentially price the lost profits (from no windfall profits).\textsuperscript{126} This strategy could also be motivated by fear of future profit regulation.\textsuperscript{127} The ETS has clearly disrupted traditional coalitional partners and stimulated the emergence of new vested interests, for example: the EIs that benefit from free permits, the generators that have invested heavily in abatement and can bank excess permits between phases, the specialised businesses that provide carbon market financial services and the political constituencies created by ring-fencing auctioning revenues for the green economy and adaptation measures.

In summary, the ETS case study is a rich crucible for developing and understanding the dynamics of Wilson’s typology. Not only do the facts demonstrate a shift from client to interest group politics and the potential for further shifts towards optimal policy prescriptions, but they also highlight the importance of informational asymmetry and collective action problems that exist in real world of regulatory politics and which Wilson’s Typology, in its classic form, overlooks. This case study also demonstrates the importance of agency by political actors to precipitate policy reform that disrupts the status quo. It therefore helps breathe life into Wilson’s typology by revealing the dynamism on both the interest group and government side of the lobbying game. Many of these insights would be lost if the shift from phase one to phase three were to be simply dismissed as attributable to the fact that windfall profits were not widely understood and that if they had, interest group politics would have surely emerged in phase one (because EIs would have mobilized earlier); an argument impossible to refute because of its counterfactual premise. However, it is precisely because ET will be a new untested policy in many jurisdictions that understanding these early stage political dynamics is so critical. The next section will consider the broader theoretical implications of these insights.\textsuperscript{128}

\textbf{Theoretical Implications}

\textsuperscript{125} See AEII press releases in Appendix Two below for evidence of their policy entrepreneurship; Ellerman, n 79 above, 293, 328.
\textsuperscript{126} Commission interviews.
\textsuperscript{127} Wettestad, n 5 above.
\textsuperscript{128} J.D. Fearon, ‘Counterfactuals and Hypothesis Testing in Political Science’ (1991) 43(2) \textit{World Politics} 169.
This case study provides evidence for and adds to the sparse literature on theoretical explanations for shifts in Wilson’s Typology, particularly shifts from client to interest group via entrepreneurial and finally majoritarian politics. It also demonstrates an interesting narrative that is testable against other policy reform case studies. That is, when new transparent public interest policies are proposed with interest group politics potential but majoritarian policy prescriptions, and where informational asymmetry (expertise) exists between regulated groups (or one group is more instrumental for policy institutionalisation), client politics is likely to emerge. This is likely to occur even if all groups appear to benefit equally before the policy is implemented. However, once one group realises that others have benefited more, the self-destruction process of client politics triggers a counter-mobilisation by losers who, through the competition mechanism that interest group politics predicts is very strong, will overcome these asymmetries relatively quickly because of the high level of sophistication, power and wealth of the major players. Demands for rents in the second round of rule-making will also be met by greater resistance. This is because the reform is embedded by having already upset existing coalitional patterns and created new vested interests that understand the potential for further rent-seeking. Therefore, not only is there a return to interest group politics, but also strong indications of a tendency towards entrepreneurial or majoritarian politics as the rules begin to resemble optimal policy prescriptions. Table Three illustrates this narrative:

Table Three: The direction and prospects of optimal policies in Wilson’s typology

<table>
<thead>
<tr>
<th>Benefits of Regulation</th>
<th>Costs of Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Concentrated</strong></td>
<td></td>
</tr>
<tr>
<td>Interest Group Politics</td>
<td>Client Politics</td>
</tr>
<tr>
<td><strong>Dispersed</strong></td>
<td></td>
</tr>
<tr>
<td>Entrepreneurial Politics (General Interest)</td>
<td>Majoritarian Politics (General Interest)</td>
</tr>
</tbody>
</table>

129 Source: Adapted from Hood, n 16 above, 25.
WHAT PROSPECTS FOR PHASE THREE?

It is too early to predict a self-correction from past disorders. The above discussion assumes less regulatory failures in phase three; specifically that recipients of free permits will not accrue windfall profits. However, existing literature that suggests carbon leakage risks are overstated is a serious cause for concern.\textsuperscript{130} A thorough analysis of this issue is beyond the scope of this paper, but it is worth briefly outlining the debate here. For example, a report by Oxford Economics predicts that moving to 100 per cent auctioning with a carbon price of €25/ton will cut EU GDP by 0.5 per cent in the medium to long term.\textsuperscript{131} A more moderate analysis by the Carbon Trust concludes that only cement, steel, and aluminium sectors are exposed.\textsuperscript{132} Others such as the IPCC, Wooders, et al, and Mattoo, et al, believe that carbon leakage will only have minimal effects.\textsuperscript{133} For example, Barker, Junankar, et al believe the impacts will be similar to variations in exchange rates.\textsuperscript{134} Indeed Reinaud found no ETS impact on carbon leakage, and a recent report by Climate Strategies warns of future regulatory failures with free allocations to EIs.\textsuperscript{135} Other risks include the economic and political fallout of border taxes on the carbon footprints of imports to prevent carbon leakage.\textsuperscript{136}

Quantifying carbon leakage is challenging, particularly because member states will push for protecting domestic industry, and evidence is only certain once displacement occurs.\textsuperscript{137} This is confirmed by the final list of exposed industries, which contains more than conservative prescriptions recommend.\textsuperscript{138} Therefore, the risk of windfall profits in phase three has not disappeared; indeed it may have increased since the failure to reach a robust international agreement at

\textsuperscript{132} Carbon Trust, EU ETS Impacts on Profitability and Trade: A Sector by Sector Analysis (London: Carbon Trust, 2007) 1; industry interview.
\textsuperscript{137} Industry interview.
Copenhagen did not trigger the review clause (of the list) in Article 10(a) of Directive Two. The debate over windfall profits and carbon leakage is likely to intensify in the literature and until an international agreement is concluded, if ever. A senior official at the commission recognises that carbon leakage is not ‘a serious problem, but the process was highly politicized and lobbied. The best can be the enemy of the good and sufficient safeguards like strict benchmarking exist to minimize problems’. Such pragmatism and optimism in politics is normal. However, there is evidence that the benchmarking process currently underway is also subject to gaming. This is a shame, because the excesses of small powerful groups at the expense of wider populations may lead to counter-excess – the potential abandonment of a useful regulatory tool (ETS) for climate change mitigation, in favour of less efficient command and control regulation.

POLICY IMPLICATIONS

The ETS case study provides further evidence that it is possible to escape the iron clutches of client politics. It instructs policymakers to potential ETS regulatory failures, particularly in relation to free grandfathered allocations. It also provides short and long-term strategies for ETS institutionalisation and demonstrates the prospects for equilibriums at optimal policy prescriptions. However, as already noted, if phase three suffers from regulatory failures, the prospects for a rising phoenix may be delayed.

This paper highlights important considerations for American and Australian policymakers who are currently negotiating climate change mitigation policies. Proposals for ETS schemes in these countries have required only 15 per cent and ~50 per cent auctioning respectively. In light of the European experience, the American figure may seem very low, but it reflects the necessary payoffs needed for long-term institutionalisation and policy learning. If the ETS case study is any indication, a move towards general interest equilibriums is possible in America and Australia if policies can clear the first legislative hurdle of institutionalisation: legislation, which at this stage in both countries is uncertain. Indeed America

140 COP-15 coincided with the date for final list adoption of industries at risk of carbon leakage by the commission in December 2009. Article 24 of the Commission Decision triggers a review of the final list if an international agreement is concluded. See n 138 above.
might abandon economy-wide ET entirely in favour of a sectoral approach or no approach at all.\textsuperscript{145} Finally, the analysis also contributes to the debate about regulatory failures and how, from a theoretical perspective, they are manageable by careful selection of MBIs.\textsuperscript{146} The rise of ET was a revolution in European environmental governance.\textsuperscript{147} This upheaval has spread because cost-effective climate mitigation


The Waxman-Markey Bill was passed by the American House of Representatives on June 26, 2009. The original proposal was 600 pages while the final proposal is 1400 pages. It is the product of severe pork-barrelling. The Kerry-Boxer Bill which followed and was before the US Senate in late 2009 provided some improvements (Resources for the Future, n 143 above). In May 2010, Senators Kerry and Lieberman introduced a 987-page bill (n 33 above) that takes a sectoral approach to climate mitigation rather than the economy-wide cap and trade will introduced in the House of Representatives. Cap and trade will apply to electric utilities primarily. However, with the loss of the Democratic Party’s super-majority in the Senate and oil spill in the Gulf of Mexico, the passage of this bill by the Senate is highly uncertain. In July 2010, the American Senate and House of Representatives introduced legislation limited to promoting energy efficiency and changing the liability architecture for offshore oil spills. Climate change legislation will have to wait until after the 2011 November mid-term elections, see Economist, ‘Capped: The Senate’s retreat from cap and trade might, one day, lead to a carbon tax, but for now leaves a dreadful mess’ (29 July 2010) \textit{The Economist}; Helm, n 7 above, 180.

However, various consultations and reiterations of the CPRS legislation have led to very generous provisions made for either free or deferred payments to emissions-intensive-trade exposed industries, the coal and electricity sectors. The actual details of the auctioning process have not been finalised. These generous provisions for polluters partly explain why the CPRS has yet to clear the legislative hurdle: see C. Johnson, ‘The CPRS - A Failure of the Left Not just the Right’ (Sydney: OnlineOpinion.com, 2010) at http://www.onlineopinion.com.au/view.asp?article=10172 (last visited 20 May 2010); J.C.V. Pezzezy, S. Mazouz, and F. Jotzo, ‘The Logic of Collective Action and Australia’s Climate Policy’ (2010) 54 \textit{The Australian Journal of Agricultural and Resource Economics} 185, 191. See, also, Department of Climate Change, ‘Summary Key Changes to the Carbon Pollution Reduction Scheme Legislation’ (Canberra: Commonwealth of Australia, May 2009) for a summary of the changes made to the CPRS bill after the public consultations, and Australian Department of Climate Change, ‘Details of Proposed CPRS Changes’ (Canberra: Commonwealth of Australia, 24 November 2009) for the changes made after negotiations with opposition parties.

The Australian Senate voted down the CPRS Bill on December 2, 2009. The legislation was introduced in the Australian Parliament for a third time on 2 February 2010. In April 2010, the Australian government decided to delay the implementation of the CPRS until after 2012 when the Kyoto Protocol expires. The August 2010 Australian Commonwealth elections which delivered a hung parliament make passage of the unpopular CPRS Bill more uncertain. See the Australian Department of Climate Change and Energy Efficiency website for up to date information: http://www.climatechange.gov.au/en/government/initiatives/eps/cprs-progress.aspx.

tools are needed by all countries. Students of history understand that revolutions almost always fail to deliver their promises. Many optimists have become ET sceptics because its exposure to rent-seeking may outweigh any benefits. In light of the result at Copenhagen the prospects for a global carbon market are quite bleak, and there have been renewed calls for a carbon tax instead, or a hybrid approach (with a carbon tax floor for EUA prices), in part because of the high levels of rent-seeking being reported in America and elsewhere. However, the ETS is displaying the green shoots of a restorative order after a policy revolution. With rent-seeking potentially resolvable in the medium term, academic ink can instead address the major issue of governance and enforceability, a more serious ‘Achilles Heel’, if ET can emerge at a global scale. This paper has therefore shown that the most important policy lesson to be learned from the ETS is not only how to reduce regulatory failures, but how to lock-in climate policy.

CONCLUSION

This paper sought to explain the change in EUA allocation rules between ETS phases one and three. It has shown that private interest theories, in addition to their multiple weaknesses, struggle to explain policy change without major shifts in actors’ interests, particularly at client politics equilibriums. This is why the hypothesis approached the question through a different analytical lens – Wilson’s Typology – a more universal framework that helps explain policy change beyond the EU. The argument defended was that the shift from client politics to interest group politics best explains the change in allocation rules between phases one and three.

The ETS case study found evidence of client politics in phase one. This is because the failure of EIs at differentiation and the resulting windfall profits of generators match Wilson’s expectations of higher rent-seeking. Moreover, the change in phase three allocation rules — industry differentiation, use of benchmarking, higher levels of auctioning, and tight exceptions for EIs — could result in lower rent-seeking, which is consistent with interest group politics expectations. Empirically, this shift can be explained by the informational and

148 n 1 above, 107.
organisational asymmetry that existed between generators and EII which was reduced in phase three and facilitated by the agency of a commission and other political actors committed to improving the ETS. It is for these reasons that the ETS case study provides such a rich crucible for understanding the dynamism in Wilson’s Typology and learning how ET can be improved over time. However, one limitation remains, it is too early to tell whether carbon leakage rules are overly lenient, which may undermine the expectation of long-term optimal policy equilibriums characterized by Wilson as majoritarian politics.

This paper has significant practical, conceptual, and policy implications. Practically, it provides one of the first factual analyses of phase three’s final directive and the first application of Wilson’s Typology to both ETS legislative phases. Conceptually, the ETS case study demonstrates shifts between client and interest group politics, an area largely ignored by the literature. As such, an important theoretical lesson can be drawn: information asymmetry between lobbying groups during new, complex, and rushed policymaking can force client politics outcomes in otherwise interest group scenarios. This empirical reality can be reconciled with Wilson’s Typology by understanding his idea of regulatory costs and benefits in a broader sense to include: transaction, collective action, and informational costs and benefits, applicable even to seemingly sophisticated, wealthy and power interest groups. The ETS case study demonstrates that these broader costs and benefits apply not only to the disparate consumers, but also to the seemingly wealthy, sophisticated and powerful; who can overcome these asymmetries relatively quickly when the lobbying game is repeated. Also, integrating policy reform theories can also help breathe life into the classic staticism of Wilson’s Typology; evidenced by the agency of the commission and other political actors that facilitated a shift from client to interest group politics. From a policy perspective, useful lessons can also be drawn about the evolution of ET. Most importantly, this paper identifies a strategy for locking-in climate policy and the potential for ET reforms to reach long-term general interest equilibriums after false starts. This very preliminary analysis provides a framework that will hopefully be validated by future research. Global climate policy could hang in the balance.
**APPENDIX ONE**

**Lobbying Positions in Both ETS Phases**

Table Four: Positions of EURELECTRIC and AEIIs in ETS phases one and three\(^{152}\)

<table>
<thead>
<tr>
<th>Phase one</th>
<th><strong>EURELECTRIC</strong></th>
<th><strong>AEIIs</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector targets:</strong></td>
<td>Believe that generators should not be the sole target</td>
<td>See Table Five</td>
</tr>
<tr>
<td><strong>Enforcement:</strong></td>
<td>Favor a voluntary cap and trade system</td>
<td></td>
</tr>
<tr>
<td><strong>Allocation:</strong></td>
<td>Favor grandfathering based on historical emissions by member states</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Phase three</th>
<th><strong>Sector target:</strong></th>
<th><strong>Sector target:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Favor all gases and sectors. Opposed to excluding small installations because of market distortions.</strong></td>
<td>Favor redesigning ETS to create an EU and global level playing field. Support the exclusion of small installations. Also favor a sectoral and performance-based allocation approach for energy intensive industries and large emitting homogenous processes.</td>
<td></td>
</tr>
<tr>
<td><strong>Allocation:</strong> If increased auctioning is inevitable then all sectors should be treated equally. Auctioning should be harmonised at the EU level. Redistribution of auctioning revenues should avoid creating market distortions. Oppose any allocation that discriminates against the electricity sector but favor principled exceptions (demonstrated by robust evidence) for industries at risk of carbon leakage until a global emission trading regime is established.</td>
<td>Against auctioning for EIIs because of risk of carbon leakage. Favor linking allocation to ambitious benchmarks. Criteria for identifying firms that qualify should be fair, transparent, and objective. Qualitative factors should be added to Commission Directive two.</td>
<td></td>
</tr>
</tbody>
</table>

---

**Electricity prices**: Against government intervention in electricity prices that undermines the EU ETS (higher prices) and liberalisation process. Also against regulation of electricity generator profits and taxation of low-carbon generation.

**Electricity prices**: Favor regulating electricity prices for EIIs or offsetting CO₂ pass-through costs using taxation for all sectors.

**Other**: Favor abandoning the option of reduced-production as a means of lowering GHG emissions in Europe. Also favor ending distortions of the free market and preventing further unequal treatment for new entrants versus incumbents.

<table>
<thead>
<tr>
<th>Table Five: Positions of AEIIIs in phase one¹⁵³</th>
</tr>
</thead>
</table>

**Abbreviations**

ACEA: European Automobile Manufacturers  
CEFIC: The European Chemical Industry Council  
CEMBUREAU: The European Cement Association  
CEPF: Confederation of European Forest Owners  
CEPI: Confederation of European Paper Industry  
CERAMIE-UNIE: The liaison office for the European Ceramic Industry  
CIAA: European Food and Drink Industries  
CPIV: the European Glass Industry  
EEA: European Aluminium Association  
EEF: the British Manufacturers’ Organisation  
EISA: European Independent Steel Works Association  
EULIA: European Lime Association  
EUROALLIAGES: European Ferro-Alloy Industry Association  
EUROFER: European Confederation of Iron and Steel Industries  
EUROMETAUX: Association representing the European non-ferrous metals industry  
EUROPIA: European Petroleum Industry Association  
EXCA: European Expanded Clay Industry Association  
IFIEC: International Federation of Industrial Energy Consumers  
OGP: International Association of Gas and Oil Producers

¹⁵³ Source: n 75 above.
<table>
<thead>
<tr>
<th>AEII</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector target:</strong></td>
</tr>
<tr>
<td>- UNICE and IFIEC wanted as many sectors and gases as possible to create as much flexibility and liquidity as possible to minimise effects on European and international competitiveness</td>
</tr>
<tr>
<td>- EUROPIA and OGP: All sectors</td>
</tr>
<tr>
<td>- EUROFER and EISA: EIASA against ETS, but EUROFER wants all sectors</td>
</tr>
<tr>
<td>- CEPI and CEPF: All sectors and include transport</td>
</tr>
<tr>
<td>- CEMBUREAU and CERAMIE-UNIE: Same sectors should be covered in all members states</td>
</tr>
<tr>
<td>- CEFIC: Wanted chemical industry excluded from ETS</td>
</tr>
<tr>
<td>- EUROMETAUX and EEA: Wanted aluminum industry excluded from ETS but as many others included</td>
</tr>
<tr>
<td><strong>Enforcement:</strong></td>
</tr>
<tr>
<td>- UNICE and IFIEC: The latter wanted voluntary opt-in and out, the former is silent</td>
</tr>
<tr>
<td>- EUROPIA and OGP: Voluntary until 2008 no possibility of opt-out</td>
</tr>
<tr>
<td>- EUROFER and EISA: Voluntary</td>
</tr>
<tr>
<td>- CEPI and CEPF: Voluntary</td>
</tr>
<tr>
<td>- CEMBUREAU and CERAMIE-UNIE: Voluntary start in 2005 no possibility of opt-out</td>
</tr>
<tr>
<td>- CEFIC: Voluntary</td>
</tr>
<tr>
<td>- EUROMETAUX and EEA: Voluntary with opt-out</td>
</tr>
<tr>
<td><strong>Allocation:</strong></td>
</tr>
<tr>
<td>- UNICE and IFIEC: Both unclear but preference for member state allocation</td>
</tr>
<tr>
<td>- EUROPIA and OGP: Free with a preference for Community level oversight and guidelines</td>
</tr>
<tr>
<td>- EUROFER and EISA: The former: favor relative targets by benchmarking and negotiated agreements at the EU level to avoid competitive distortions. The latter: in favor of auctioning</td>
</tr>
<tr>
<td>- CEPI and CEPF: The former: Grandfathering based on common baseline. Targets set by negotiation, allocation by member states but with harmonisation of rules and compliance at community level. The latter: not specific.</td>
</tr>
<tr>
<td>- CEMBUREAU and CERAMIE-UNIE: The latter: in favor of auctioning but unclear about EU role other than trading should be operational internationally. The former: against with EU role in harmonisation</td>
</tr>
<tr>
<td>- CEFIC: Free member state allocation and based on negotiated agreements with trade associations</td>
</tr>
<tr>
<td>- EUROMETAUX and EEA: No allowances, instead industry targets should be established, unclear on EU role although implicit that sectors means community</td>
</tr>
</tbody>
</table>
COMMISSION PROPOSALS AND DIRECTIVES

Table Six: Phase one comparison of Green Paper and final directive\(^\text{184}\)

<table>
<thead>
<tr>
<th>Sector target</th>
<th>Green Paper</th>
<th>Directive One</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 GHG</td>
<td>Article 2 (I) and Annex I &amp; II: CO(_2). But other gases if possible (Article 24)</td>
<td></td>
</tr>
<tr>
<td>Feasibility of energy generators &gt;50MWth</td>
<td>Article 2 (I) and Annex I: Energy generators &gt;20MWth</td>
<td></td>
</tr>
<tr>
<td>Iron, steel, minerals, cement, pulp and paper, refineries, aluminum, chemical</td>
<td>Article 2 (I) and Annex I: Iron, steel, minerals, cement, pulp and paper, refineries. Aluminum, chemical if possible</td>
<td></td>
</tr>
<tr>
<td>Opt-in and Opt-out (i.e. voluntary or mandatory)</td>
<td>Article 27: Mandatory. But opt-in for installations below level in directive, temporary opt-out for installations</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Initial allocation</th>
<th>Green Paper</th>
<th>Directive One</th>
</tr>
</thead>
<tbody>
<tr>
<td>For free/grandfathering</td>
<td>Article 10: 95% and 90% for free in phase one and phase two respectively</td>
<td></td>
</tr>
<tr>
<td>Preference for auctioning</td>
<td>Article 9: Allocation by member states, EU can reject according to Internal Market Rules and allocation to follow Burden Sharing path</td>
<td></td>
</tr>
<tr>
<td>Preference for allocation by EU</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocation by MS-EU rules/guidelines for allocation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table Seven: Phase three comparison of Commission Proposal Two with Directive Two\(^\text{185}\)

\(^\text{184}\) Source: n 70 above; n 68 above; Markussen and Svendsen, n 6 above, 256.
<table>
<thead>
<tr>
<th><strong>Commission Proposal Two</strong></th>
<th><strong>Directive Two</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector targets</strong></td>
<td><strong>Annex I &amp; II</strong></td>
</tr>
<tr>
<td>New gases: N20 and perfluorocarbons</td>
<td>Same, but also includes: carbon capture, transport and geological storage of all greenhouse gas emissions</td>
</tr>
<tr>
<td>New sectors: petrochemicals, ammonia, aluminum, acid (nitric, adipic, glyoxylic) Aviation is covered in a separate proposal(^{156})</td>
<td>Aviation included as of 2012 (Separate Directive(^{157}))</td>
</tr>
<tr>
<td>Excluded small installations &lt;25MW and lower than 10,000 tones of CO(_2) for each of last three years</td>
<td>Excluded small installations: &lt;35MW and lower than 25,000 tones each of last three years.</td>
</tr>
<tr>
<td><strong>Total level of auctioning</strong></td>
<td><strong>Phase three estimate: 66%</strong></td>
</tr>
<tr>
<td>Phase three estimate: 100% auctioning in all sectors by 2020 (with exception for industries at risk of carbon leakage)</td>
<td>Phase three estimate: 50% 100% auctioning in all sectors by 2027 (with exception for industries at risk of carbon leakage)</td>
</tr>
<tr>
<td><strong>Allocation for generators</strong></td>
<td><strong>Article 10 (c)</strong></td>
</tr>
<tr>
<td>100% auctioning</td>
<td>Option for Members State derogation of 100% auctioning if satisfy test: (1) level of interconnectivity; or (2) % fossil fuel generation. Derogations require minimum 30% auctioning and full auctioning by 2020</td>
</tr>
<tr>
<td><strong>Allocation for EIIs</strong></td>
<td><strong>Article 10 (b)</strong></td>
</tr>
<tr>
<td>Free but subject to review after Copenhagen COP 15</td>
<td>Free but subject to review after Copenhagen COP 15</td>
</tr>
<tr>
<td><strong>Methodology for Identification of Industries at risk of</strong></td>
<td><strong>Article 10 (a)</strong></td>
</tr>
<tr>
<td>Not detailed: ‘inability to pass through the cost of required allowances in product prices without significant loss of market’</td>
<td>More detailed: direct and indirect additional production costs as a proportion of gross value</td>
</tr>
</tbody>
</table>

\(^{155}\) Source: n 73 above; n 74 above, n 124 above; Commission (EC), ‘Questions and Answers on the Revised EU Emissions Trading System’ (Memorandum) MEMO/08/796, 17 December 2008.


<table>
<thead>
<tr>
<th>significant carbon leakage</th>
<th>share to installations outside the EU not taking comparable action to reduce emissions’.</th>
<th>added exceed 5% and whether total value of its exports and imports divided by the total value of its turnover exceeds 10%. If the result of either of these criteria exceeds 30%, a sector is considered at risk of significant carbon leakage.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation for electricity price pass-through</td>
<td>No provision</td>
<td>Article 10(a) Compensation for costs relating to greenhouse gas emissions passed through in electricity costs. This will be subject to modified state aide rules. Based on ex ante benchmarks of electricity consumption per unit of output based on best available technology and CO₂ emissions of the relevant European electricity production mix.</td>
</tr>
<tr>
<td>Provisions for new market entrants</td>
<td>5% of the total quantity of allowance will be put into reserve for new installations or airlines that enter the system after 2013. Allocation from this reserve will mirror rules for allocation corresponding to existing installations or sectors Remaining allowances will be distributed to Member states for auctioning. The distribution key is the same as for all other allowances to be auctioned.</td>
<td>Article 10(a) Same except: A part of new entrant reserve, amounting to 300 million allowances will be made available to support the investments in up to 12 demonstration projects using the carbon capture and storage technology and demonstration projects using innovative renewable energy technologies. Remaining allowance distribution will take into account the level to which installations in Member states benefited from the reserve.</td>
</tr>
</tbody>
</table>
APPENDIX TWO

MEMBERS OF THE AEII ON 2 DECEMBER 2008

<table>
<thead>
<tr>
<th>ACEA</th>
<th>EULA</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEFIC</td>
<td>EUROALLIAGES</td>
</tr>
<tr>
<td>CEMBUREAU</td>
<td>EUROFER</td>
</tr>
<tr>
<td>CEPI</td>
<td>EUROMETAUX</td>
</tr>
<tr>
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<tr>
<td>CPIV</td>
<td>IFIEC</td>
</tr>
</tbody>
</table>

AEII PRESS RELEASES


AEII, ‘The Impact of EU Emission Trading Scheme (ETS) on Power Prices: Remedial Action Urgently Needed 10 Months After Start of ETS’ (November 2005) at

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http://www.cembureau.be/Cem_warehouse/ALLIANCE%20ETS%20AND%20POWER%20PRICES.PDF (last visited 1 August 2009)


APPENDIX THREE

INTERVIEWS

Industry

Interview 1: Representative of the Bryman Partnership: Business & Environmental Consultancy, representing the Confederation of Paper Industries at the UK

