

# **EU Emissions Trading: Legitimacy and Stringency**

Draft

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## Abstract

The stringency and potential effectiveness of the EU Emissions Trading System (EU ETS) has increased with the revisions adopted in December 2008. This article explores whether the increase in stringency has been based on a corresponding broadening of the basis for legitimacy. The EU has increasingly departed from the legitimacy basis of state consent by applying qualified majority voting and direct regulation at non-state level to improve the effectiveness of environmental policy. In turn, these developments have increased the need for multi-level legitimacy at various levels of society. The main conclusion is that the recent increase in the stringency and potential effectiveness of the EU ETS has indeed been based on a broader legitimacy basis. However, a broader legitimacy basis does not necessarily ensure widespread acceptance and support in the future. Much will depend on the system's capacity to deliver significant results.

## 1. Introduction

In December 2008, the EU adopted a new climate and energy policy for Europe. The declared cornerstone in the new package of binding measures is a significant strengthening of the EU Emissions Trading System (ETS). The new system is intended for operation from 2013 until 2020 and beyond, with the next scheduled revision by 2025.<sup>1</sup>

Alongside the development of the ETS, emissions trading has encountered significant criticism particularly related to normative justification and the legitimacy of carbon markets (Ott and Sachs, 2000; Lefevere, 2005, p. 92; Paterson, 2007; Paterson, 2009; Carbon Trade Watch). In March 2009, demonstrators outside the Bella Centre in Copenhagen directed their anger at buyers and sellers of emission allowances during the annual Carbon Market Insight Conference: Our climate is not your business! Our climate is not your business!<sup>2</sup>

In light of such criticism and the few possibilities for ETS review over the next decade, this article sets out to explore the legitimacy basis of the EU ETS. Has the increase in stringency and potential effectiveness been based on a corresponding broadening of the basis for legitimacy?

This question will be approached by assessing the normative justification and sources of legitimacy at different levels of society over time, as these two elements make up the legitimacy basis of the system. This approach links the study of EU climate policy to theories

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<sup>1</sup> However, the present system may be amended in light of a new the international climate agreement.

<sup>2</sup> Reported by the Norwegian daily *Dagens Næringsliv*, 21/22 March 2009.

of legitimacy and EU policy-making, and complements the growing social science literature on the EU ETS which has mainly been concerned with explaining, describing and evaluating the evolution and consequences of the system.<sup>3</sup>

Since 2005, the EU ETS has regulated CO<sub>2</sub> emissions from over 10,000 industrial installations in 25 (27 as of 2006) EU member states representing close to half of the EU CO<sub>2</sub> emissions. These installations and countries have received fewer emission allowances over time and will receive even less in the future to meet the EU 20% greenhouse gas reduction target by 2020. Scarcity of emission allowances to industry will promote higher prices on allowance and greater incentives to cut emissions. Scarcity is likely to increase the stringency and environmental effectiveness of the EU ETS.

Other developments give rise to questions about legitimacy. Although industrial installations have been designated as the core operators within the system, companies have no formal decision-making power in the EU. The EU ETS was adopted on the basis of qualified majority voting, and twelve of the current EU member states were not EU members when the system was adopted in 2003. Finally, the idea of emissions trading in Europe has been controversial, and the instrument has been challenged for being morally reprehensible as well as questionable with regard to equity (Ott and Sachs, 2000).

In the following section, an analytical framework is developed for exploring the legitimacy basis of the EU ETS. The third section provides a snapshot of the development in the stringency of the system. The fourth section assesses how the ETS became normatively justified and how the basis for legitimacy was crafted when the system was made. The fifth section explores change in the legitimacy basis when the system was revised in 2008, followed by an analysis of the relationship between legitimacy and stringency over time. Finally, some concluding remarks are presented.

## **2. Multilevel governance and legitimacy**

Legitimacy can generally be understood as acceptance of political authority. What gives the right to govern and the duty to comply is an old philosophical problem that has spurred a sizable literature.<sup>4</sup> The way we understand EU (here: environmental) policy-making is important for how we understand legitimacy (Føllesdal (2000)). In recent years, multilevel governance models have developed as an alternative to liberal intergovernmentalist models

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<sup>3</sup> For a brief review of the literature, see Skjærseth and Wettstad (2009).

<sup>4</sup> See for example, Hurd (1999) and Bodansky (2007) for an introduction to this literature

for understanding EU integration and policy-making (Marks *et al.*, 1996). This is particularly the case for EU environmental policy, where decision-making competencies and influence are shared at several levels of government (Weale *et al.*, 2000; Fairbrass and Jordan, 2004). The EU ETS serves as a prime example in this regard, designating competence to industry, member states, the community institutions and the international climate regime.

Different variants of multilevel governance models have developed since Gary Marks' original model, but they all share some common assumptions about European integration having weakened the state (Marks, 1992; Marks *et al.*, 1996; Hooghe and Marks, 2001). By contrast, the core claim of the state-centric intergovernmentalist model is that policy-making in the EU is determined primarily by: 'national governments constrained by political interests nested within autonomous national areas' (Hooghe and Marks, 2001, p. 3. See also Moravcsik, 1999).

It follows from the liberal intergovernmentalist model that legitimacy is mainly a question of consent between sovereign states based on international law, which is generally regarded as a legitimate base of obligation (Bodansky, 2007). Non-state actors form part of domestic societal interests that shape negotiating positions, and bargaining outcomes are mainly determined by the relative interests and preferences of national governments. Policy outcomes will accordingly reflect the relative interests and strength of the member states, and scant flexibility to make concessions will drive EU agreements toward the lowest common denominator (Marks *et al.*, 1996; Fairbrass and Jordan, 2004; Hovi and Sprinz, 2006). This is particularly the case in issue-areas where significant interests are at stake, such as security or energy policy. Consent increases the influence of each member state on the system, but reduces the likelihood that all will agree to the same system.

From the multilevel governance model, it follows that state consent needs to be complemented by additional sources of legitimacy. In essence, the notion of multilevel governance presupposes *multilevel legitimacy* based on a variety of sources at different levels of society. In addition to state consent, public participation and transparency, democracy and expertise and effectiveness have been suggested as further sources of legitimacy (Bodansky, 2007). In the following we explore these sources in light of three claims made by multilevel governance models explaining how the role of member states has been reduced by qualified majority voting, by direct influence of non-state Euro-federations on collective EU policy, and by independent influence by supranational institutional actors exceeding their role as agents for national governments.

First, indirect consent among and between states gives rise to legitimacy concerns. ‘Indirect consent’ refers to general consent among member states to apply qualified majority voting. General consent to outvote member states does not necessarily guarantee high legitimacy with regard to specific decision-making processes and obligations, since a state cannot know which constraints may apply in the future (Bodansky, 2007, p. 714). This leads us to the first assumption: A rise in the consent of the EU member states that are committed by the system will broaden the legitimacy base of the EU ETS. Consent under qualified majority is more common than voting in the EU, but it is no guarantee for high legitimacy. Even if formal voting does not take place, the possibility to do so still creates pressure to make concessions – a phenomenon described as the ‘shadow of the vote’ (Weiler, 1991). Such pressure implies that states may agree reluctantly.

Secondly, qualified majority voting and direct regulation at the non-state level have increased the mobilization of non-state actors at the EU level.<sup>5</sup> When EU policies regulate non-state actors, the legitimizing force of state consent will decrease while the need to facilitate broader participation at the EU level will increase. Participation and transparency correspond with process-based theories of legitimacy emphasizing that authority can be legitimated by the process rights, such as the right to be heard. This means that acceptance of decisions and trust in public authorities is enhanced if the public has a say (Bodansky, 2007, p. 710). Public participation and transparency constitute additional sources of legitimacy in a multilevel context by making governments more accountable to non-state actors affected by their decisions. This line of reasoning leads us to the second assumption: Increase in participation and consent of non-state actors that are committed by the system and that represent the public interest will broaden the legitimacy base of the EU ETS. Consent by non-state actors can emerge either from their influence on the system, or by the influence of the EU institutions on their positions (or a combination).

Third, multilevel governance models imply that supra-national institutions, such as the European Commission and Parliament, tend to have an independent influence on policy-making that exceeds their role as agents for national governments (Hooghe and Marks, 2001, p. 3). This means that individual governments do not have full control over collective decision-making, even in vital issue-areas like energy and climate policy. In addition to public participation, the EU institutions can bring in democracy and expertise as two additional

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<sup>5</sup> Qualified majority voting implies that lobby groups cannot block a decision by affecting the position of one or a minority of states.

sources of legitimacy. There is a major debate over a ‘democratic deficit’ in the EU (Føllesdal and Hix, 2006). According to liberal intergovernmentalism, the EU remains largely an intergovernmental organization and accordingly will not necessarily suffer from a democratic deficit. Conversely, it follows from multilevel governance models that intergovernmentalism is insufficient to ensure democracy. Since the European Parliament is the only directly and popularly elected body in the EU, the ‘democratic deficit’ argument has been linked to the notion that the EP is too weak.<sup>6</sup> In specific decision-making processes based on co-decision with the Council of Ministers, however, the EP can affect the outcome of policies initiated by the Commission. Against this backdrop, we assume that unified support from the EP in specific decision-making processes will broaden the legitimacy base of specific proposals.

Expertise and effectiveness have also been floated as a legitimate basis for decision-making (Bodansky, 2007; Alvarez, 1991, p. 207). Expert advice is valued on substantive grounds for producing desirable outcomes if followed up by policy-makers, such as the role of the International Panel on Climate Change in diagnosing the problems of climate change. Since external agencies and the European Commission have been the main providers of expertise in the EU ETS process, we assume that a high degree of match between expert advice and the design of emissions trading systems will broaden the legitimacy base.<sup>7</sup>

The relationship between technical expertise and legitimacy is complex. Few would question the emissions-reduction potential of an extremely high CO<sub>2</sub> tax or allowance price – say 200 euros per tonne. This example illustrates the limitations of expertise as a source of legitimacy. In the end, such decisions are political ones, based on values. A tax or allowance price of this magnitude will have various other economic, political and social consequences for policy-makers, consumers and producers of fossil fuels. Accordingly, legitimacy has a normative dimension in addition to an empirical one. Popular legitimacy is related to acceptance by those actors subject to governance, whereas normative legitimacy is related to the right to make decisions or whether the policy instrument is normatively justified (Bodansky, 2007). Normative justification is a necessary, but not sufficient, condition for popular support.

Transforming the above assumptions into empirical expectations in light of the EU ETS case involves several challenges. First, legitimacy tends to be treated as a source of

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<sup>6</sup> For other ‘democratic deficit’ arguments, see Føllesdal and Hix, (2006, p. 536) and Føllesdal (2008, pp. 380–383).

<sup>7</sup> It is reasonable to expect that the legitimizing force of expert advice will depend on the degree of scientific consensus and uncertainty. This is not explored here due to space limitations.

compliance distinct from power and self-interest (Hurd, 1999). Acceptance by actors subject to regulation may thus be rooted in mechanisms other than legitimacy, such as self-interest. Distinguishing empirically between different mechanisms requires knowledge of the actor's motivations, and that is extremely difficult (Hurd, 1999, pp. 390–392). In this study, as noted, we focus on a combination of normative justification and sources of legitimacy at different levels of society over time.

Legitimacy has been related to various aspects of authority, such as properties of decision-making processes and rules structuring the exercise of authority (Franck, 1990, p. 24; Bodansky, 2007, p. 706). From a political science perspective, we may relate the sources of legitimacy to properties of decision-making, decisions and the results.<sup>8</sup> The sources of legitimacy discussed above can thus be organized according to: a) transparency and participation in the decision-making processes and system; b) the correspondence between decisions and organizational and other actors' expressed preferences that bring in various sources of legitimacy (member states, non-state actors, the European Parliament and the Commission; c) the results achieved (does the 'cure' work?). As legitimacy cannot be measured directly, we assume that a broader legitimacy base will increase the probabilities for robustness and compliance, particularly when change in justification and acceptance appear unrelated to change in self-interest or power.

Second, a narrow conception of compliance in the context of the EU ETS can be defined as having sufficient allowances at the level of installations to cover total emissions during the previous compliance period. Emissions trading requires systems to ensure that the figures that governments cite to demonstrate compliance are real, and that the financial penalty is sufficiently high to ensure that operators will buy from the market a sufficient number of allowances to cover the installation's actual emissions. Compliance is thus based on rational incentives, and does not necessarily require legitimacy to be effective. However, the level and stringency of a cap-and-trade system will be determined by the stringency of the cap that specifies the total amount of emission allowances (in tons of CO<sub>2</sub>), and various other design elements affecting the resultant reduction in emissions. Accordingly, the focus here will be broader, and concerned with the legitimacy basis of the design of the cap-and-trade system itself. Finally, in line with Franck (1990, p. 26), we assume that the legitimacy base is a matter of degree, as compliance or the stringency of emissions trading is a matter of degree.

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<sup>8</sup> Thanks to Arild Underdal for clarifying this point.

In brief, then, multilevel governance in practice requires multilevel legitimacy based on normative justification of the system and a variety of legitimacy sources at different levels of society.

### **3. The EU ETS: greater stringency and potential effectiveness**

The EU ETS policy-making process has developed in two main phases.<sup>9</sup> The first phase led to the 2003 Emissions Trading Directive covering the first (2005–2007) and second (2008–2012) trading periods. The ET directive was supplemented by the 2004 Linking Directive, linking the EU ETS to the Kyoto Protocols' Joint Implementation (JI) and Clean Development Mechanisms (CDM). In this phase, the amount of allowances was determined by each state, and the total EU cap represented the aggregate of each state's National Allocation Plan (NAP). The decentralized *level of the cap* led the member states to allocate close to projected needs or more, leading to 4% more allowances than actual emissions in 2005 (over-allocation). As a consequence, the allowance price dropped to almost zero in the spring of 2007 (Skjærseth and Wettestad, 2008). Allowances were mainly *allocated* free of charge. This system was administratively complex and cumbersome for the member states, and led to windfall profits to power producers who could pass on the estimated costs of allowances to customers even though they had received them free of charge. Finally, the EU ETS was *linked* to the Kyoto Protocol mechanisms, and credits could be purchased through CDM and JI. This led to serious fears that a massive inflow of cheap CDM credits from third countries could reduce incentives for emissions reduction in Europe.<sup>10</sup> The system covered CO<sub>2</sub> emissions from energy-intensive industries (pulp and paper, cement, glass and ceramics, refineries, ferrous metals) and power producers (combustion plants). The combination of a cap based on the sum of NAPs, free allocation and liberal access for credits, led to a weak system that could provide only scant incentives for industry to reduce emissions.

The EU ETS was significantly strengthened in the second phase, leading to the revised emissions trading system adopted in December 2008. This revised system is to apply to the third trading period from 2013 to 2020, and beyond. The revised ETS does away with the NAPs and introduces a single EU-wide cap. Allowances will be allocated on the basis of fully harmonized rules. The level of the EU-wide cap is calculated on the basis of the 20% reduction in greenhouse gases target by 2020 at 1990 levels, which is equivalent to 14%

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<sup>9</sup> Important changes also took place between these main phases.

reduction compared to 2005.<sup>11</sup> Auctioning became the principal allocation method based on a differentiated system between the power sector and energy-intensive industries. The new auctioning rules are complex, with derogations for the power sector in the new member states and industries in danger of so-called carbon leakage (i.e. sectors that might be forced by the ETS revision to relocate production to third countries with more lenient constraints on emissions), but the general principle is that the power sector will have to buy all of its allowances from 2013 on, while other industries will need to buy at least 20% of their allowances in 2013, increasing to at least 70% by 2020 and with a view to of reaching 100% by 2027. A cap has been introduced on the use of imported credits, allowing an overall use of credits limited to 50% of the EU-wide reductions for the period 2008–2020.<sup>12</sup> The scope of the system has also been expanded to new sectors (petrochemicals and aluminium) and greenhouse gases.<sup>13</sup>

The combination of a more stringent cap for the EU as a whole, allocation for payment and limited access of new credits represents a development towards a significantly more stringent system.

## 4. Crafting EU ETS legitimacy

### Normative justification

To explore whether the strengthening of the system has been based on a corresponding broadening of the basis for legitimacy we first need a baseline. As normative justification is a necessary condition for popular support, we begin with how the idea of the EU ETS was accepted. Emissions trading emerged in economic science in the 1960s and in US practice from the 1980s (Voss, 2007). Based on the experience with emissions trading at home, the USA pushed hard to get emissions trading included in the Kyoto Protocol in 1997. The EU initially opposed the idea, but had to accept international emissions trading in return for binding numerical targets and timelines (Grubb *et al.*, 1999). European resistance was based on a combination of effectiveness concerns and normative objections. The effectiveness

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<sup>10</sup> A cap on import was first introduced in 2006, in relation to the process of producing NAPs for the period 2008 to 2012 period.

<sup>11</sup> The linear reduction adopted amounts to 1.74% per year, arriving at 21% below 2005 emissions (and 10% for sectors not covered by the EU ETS).

<sup>12</sup> The EU's overall reduction target will be increased by up to 30% if a satisfactory new international climate agreement is adopted. Then, half of the extra effort required by ETS installations may be covered by external credits.

<sup>13</sup> Aviation will be included from 2012, but this was decided prior to the reform.

concerns were caused by so-called ‘hot air’, particularly from Russia, that could lead to import of excess emission allowances. Normative objections were based on equity concerns – that more affluent industrialized countries could simply buy their way out of their obligations, without altering their disproportionate consumption of scarce resources (Ott and Sachs, 2000). Such objections were also based on the argument that it was wrong to treat pollution as a commodity that could be bought and sold in the market.

The European Commission started to turn on the issue in 1998. Between 1998 and 2000, the European Commission took the initiative to the EU ETS. It built up knowledge largely based on US experience, and crafted support among stakeholders (Skjærseth and Wettestad, 2008). A European emissions trading system would avoid two of the main objections to emissions trading under the Kyoto Protocol. First, trading would take place between industrial countries, and the problem of ‘hot air’ would not apply to an EU ETS – at least not to the same extent, since Russia did not participate. Secondly, a European system would not have to confront equity concerns in relation to developing countries to the same extent. The remaining normative issue of whether it was right or wrong to trade in pollution as a commodity was gradually overcome by the belief that a cap-and-trade system could guarantee a positive environmental outcome, if appropriately designed.

By around 2000, most opponents had turned into supporters of the idea of emissions trading in Europe (Zapfel and Vainio, 2002). With the acceptance of the idea of emissions trading, the legitimacy of the EU ETS became a question of popular support for how the emissions trading system should be modelled.

### **Initiating the system**

The European Commission had no experience with emissions trading and scant awareness of what an EU ETS could or should look like. In January 1999, the Foundation for International Law and Development (FIELD) and the Centre for Clean Air Policy (CCAP) in Washington were commissioned by the Commission to undertake a study of design option for an EU ETS (FIELD, 2000; CCAP, 2000).

In 2000, the European Commission presented the Green Paper (GP) on greenhouse gas emissions trading within the European Union (European Commission, 2000a). The GP discussed how emissions trading could be organized; most of the recommendations from CCAP and FIELD found their way into the GP (Skjærseth and Wettestad, 2008). The European Commission argued for a mandatory cap-and-trade system, with a cap agreed at EU

level or a high degree of harmonization, and payment for allowances in the form of auctioning and enforcement based on penalties.

The Green Paper also initiated two consultation processes – one exclusive and one inclusive. The inclusive process served the function of transparency by spreading the word about the planned system. It also included a consultative element by providing stakeholders with the right to be heard. The Green Paper included ten questions to stakeholders, and some 70 non-state actors commented upon the GP and replied to the questions. Beyond the general support to emissions trading as a good idea and the need for penalties in cases of non-compliance, there were few areas of consensus with regard to the design of the system. Industry opposed an EU-level cap and payment for allowances, while environmental non-governmental organizations (ENGOS) wanted both. Energy-intensive industry preferred a weaker baseline and credit system based on relative targets, rather than a mandatory cap-and-trade system.

The exclusive consultation process was initiated under the European Climate Change Programme (ECCP) Working Group 1 (WG1) on ‘Flexible Mechanisms’, and ten meetings were held between July 2000 and 2001. Participants were carefully selected by the European Commission. A small group of 19 participants representing 17 organizations was set up to include representatives assumed to be positively inclined towards emissions trading, and those with a substantial interest in the issue (European Commission, 2000b). This group, however, represented only a fraction of the 70 organizations that had responded to the Green Paper. The group was composed of key stakeholders, chosen with a view to crafting consensus rather than ensuring broad participation and legitimacy. The group unanimously recommended that emissions trading should start as soon as practicable (European Commission, 2001). However, there was still disagreement on important design issues such as allocation methods. Against this backdrop, the Commission stepped up its efforts to propose the ET directive by 2001. This spurred fierce criticism from industry arguing that consultation had been inadequate (Skjærseth and Wettestad, 2008, p. 122).<sup>14</sup> In the proposal for the Linking Directive, the Commission argued for a common cap on the import of credits to prevent ‘perverse effects’ from the inflow of cheap CDM and JI credits (Flåm, 2008, p. 28). This was supported by the ENGOS, but was opposed by industry.

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<sup>14</sup> The Commission responded by convening a new consultation meeting with representatives from industry and ENGOS in September 2001.

## **Decision-making**

The European Commission proposed the ET Directive in October 2001. The proposal was based on Article 175(1) and the co-decision procedure set out in Article 251 of the European Community Treaty. This legal basis provides for qualified majority voting in the Council; it allows member states to be outvoted and the European Parliament to veto a proposal.

Two major member states, Germany and the UK, opposed a mandatory system as proposed by the Commission. Their first line of defence was to change the legal basis pursuant to Article 175(2), which requires unanimity. This was, however, unsuccessful, as the proposal failed to satisfy the conditions for that Article (Meadows, 2006, p. 65). Negotiations in the Council had to be postponed due to German opposition right up until the common position was adopted in December 2002 (Lefevere, 2005, p. 101). Germany and the UK had to yield and accept a mandatory system, partly due to the threat of becoming outvoted (Skjærseth and Wettestad, 2008). Even though some concessions were made to Germany in particular, it had to accept a mandatory EU ETS for the first trading phase, 2005–2007. In the end, the ET Directive was adopted by a unanimous Council of Ministers.

The eight Central and East European Countries (CEECs) as well as Malta and Cyprus were candidate countries for EU membership at the time the ET Directive was negotiated. All CEECs were parties to the Kyoto Protocol with obligations as ‘Economies in Transition’. The CEECs were included late in the ETS decision-making process. From late 2002, the CEECs were granted access to an ‘Interim Committee’, allowing them to comment on EU draft legislation concerning the signature of the Accession Treaties (Fernandez Armenteros and Massai, 2005). Their positions were mixed, with Poland, Hungary, Latvia and Lithuania critical to the emerging ET directive. The CEECs were also included as observers in the final stages of the decision-making process, including the second reading in the European Parliament and the final deliberations in the Council in the first half of 2003. However, the CEECs had very limited opportunity to influence the actual decision-making process, as the EU-15 had already agreed on a common position in December 2002. Hungarian officials complained that ‘the scheme was designed without keeping in mind the needs of the new member-states’ (Skjærseth and Wettestad, 2007, p. 271).

The European Parliament held its first reading on the proposed ET directive in the spring of 2002. The EP was far from satisfied with the proposed directive and tabled some 80 amendments. The EP wanted more auctioning, a wider scope (including chemicals and aluminium) and the cap to be fixed at the EU level. Most proposed amendments were based on large majorities in the EP: the exception was the call for more auctioning, which was

passed by a majority of only three votes (Skjærseth and Wettestad, 2008, pp. 128–129). None of these amendments was accepted by the Council of Ministers. The second EP reading took place in the spring of 2003, where the EP decided to re-table 25 amendments. In the end, the EP had to yield on most issues concerned with the cap, scope and allocation method. Still, only four votes were cast against the ET Directive at the final reading in Parliament (Vis, 2006, p. 40). One important reason for this broad EP support was that the EU did not have time for further decision-making to get the system in place to comply with the Kyoto Protocol commitments (Skjærseth and Wettestad, 2008). In the negotiations on the Linking Directive, the EP supported the Commission's proposal for a cap on imported credits, whereas a majority of the member states opposed a cap (Flåm, 2008).

## **5. Reforming the EU ETS: Change in legitimacy basis?**

### **Initiating reform**

The second phase of the European Climate Change programme was launched in October 2005 (ECCP II) by a stakeholder conference attended by over 450 delegates representing all major stakeholders. The purpose was partly to take stock of experience so far and partly to develop new policies beyond 2012. The Commissioner for the Environment, Stavros Dimas, opened the conference by stating: 'Let me assure you that the programme will continue to respect the ECCP principles of stakeholder consultation, transparency....This is why all working groups comprise a wide range of different stakeholders, stemming from many different interests' (Dimas, 2005, p. 5).

Pursuant to Article 30 in the 2003 ET Directive, the Commission was to draw up a report on the application of the Directive by June 2006, accompanied by proposals for amendments. The European Commission commissioned McKinsey & Co. and Ecofys to assist in the review in 2005 and 2006. These consultancies produced various reports based on surveys – all published on the Commission's web site. The reports provided an overview over most relevant issues and the positions of various stakeholders, contributing to enhancing transparency in the review process.

The Commission also set up a High-Level Group (HLG) on energy, environment and competitiveness that met for the first time in February 2006. This group enhanced participation to other policy areas that affect, and are affected by, the EU ETS (HLG, 2006). The surveys and the HLG recommendations were fed into the Commission's report on the application of the ET Directive, published in November 2006 (European Commission, 2006).

Here, the Commissions explicitly states: ‘The Commission has considered the issues listed in Article 30 *as well as further issues highlighted by stakeholders*, taking some additional time to do so’ (European Commission 2006, p. 2, emphasis added). This indicates that the views of stakeholders had not only been heard but had in fact influenced the agenda for the review.

The ECCP II Working Group on the review of the EU ETS had four meetings in the spring of 2007.<sup>15</sup> The main difference from WG1 in 2000 was that the number of participants was now much higher – around 100 – and that all types of stakeholders were included: the Commission, the 27 EU member states, industry, ENGOs and even the European Parliament.

With regard to specific positions, the main changes involved more support to the harmonized cap-setting by industry to ensure a level playing field, and more positive ENGOs (European Commission, 2007, p. 3). In fact, the ENGOs had now become the most enthusiastic supporters of ETS. In a common position paper on the EU ETS review process in 2007, CAN, WWF, Friends of the Earth and Greenpeace stated: ‘The existence of the EU emissions trading scheme is a tremendously important achievement for European Climate Change policy’ (CAN-Europe, 2007, p. 5).

Against the backdrop of the various consultation processes and the positions of key stakeholders, the Commission presented its proposal for the revised ET Directive in January 2008. The proposal formed part of the EU climate and energy package, including proposed legislation on carbon capture and storage, renewable energy sources, and national emissions targets for sectors outside the ETS.

## **Decision-making**

The Environment Council discussed the proposed ETS revision for the first time in March 2008. All CEECs were now full members of the Council. In general, the ministers welcomed the direction of the proposed changes (Environment Council, 3 March 2008), but two main areas of disagreement unfolded in the negotiations. First, the CEECs demanded more economic ‘solidarity’ than originally included in the Commission proposal; and secondly, energy-intensive industry at risk of carbon leakage demanded free allowances. These demands were put forward with increasing intensity, fuelled by the global economic crisis that began to unfold in the autumn of 2008.

At the European Council in October, all CEECs led by Poland issued a statement declaring that any agreement on the climate package must reflect differences in countries’

‘economic potential’ at a time of ‘serious financial difficulty’ (Joint Statement, 2008; Euractiv, 16 October 2008; ENDS, 6 November 2008).<sup>16</sup> The summit ruled out delaying the adoption of the climate package despite calls from Poland and Italy to do so in light of the global financial crisis. Alongside the CEECs, Germany demanded more liberal criteria to single out industries exposed to carbon leakage until an international climate agreement could impose comparable costs to industries outside the EU (ENDS, 20 October 2008; ENDS, 20 November 2008).

The Parliament generally supported the Commission’s proposal, as the proposed revisions were mainly in line with the EP positions in the first decision-making phase. The EP’s *rapporteur* for the ETS proposal emphasized the ‘unprecedented cooperation across political groups that is currently taking place...’ (European Commission, 2008b, p. 1). Most of the proposed amendments concerned relatively minor issues, such as a funding mechanism for carbon capture and storage (European Parliament, 2008; ENDS, 7 October 2008).

The French presidency was determined to forge a compromise by 2008, in order to influence the international climate negotiations leading up to the Copenhagen negotiations in December 2009. One tool used by the French was to elevate decision-making from the Council of Ministers to the European Council and decide on the ETS revision and the climate package in one single round at the same time. Negotiations involving the Parliament, Commission and the Council were to achieve a solution by December 2008. This move placed significant pressure the Parliament to accept the proposal at the first reading after the heads of states had agreed. The EP’s acceptance of reducing its real co-decision power should be understood in light of its general satisfaction with the proposed directive as well as the final outcome. Another tool was to announce that the package should be adopted by unanimity instead of qualified majority. This move increased the influence of each member state on the system and can help to explain why the final compromise included less auctioning than proposed by the Commission, more revenues from auctioning to a solidarity fund for the CEECs, more lenient criteria for industries at risk of carbon leakage, and somewhat more liberal CDM import rules. The EP also got its share of the compromise by securing more funding to finance carbon capture and storage. The EU-wide cap proposed by the Commission remained unaltered.

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<sup>15</sup> Ensuing protests by industry resulted in two *ad hoc* consultation meetings in 2008 with stakeholders within the ECCP II (European Commission, 2008a).

<sup>16</sup> They also preferred more flexibility with regard to the proposed 2005 baseline year, to recognize achievements in greenhouse gas reductions among the CEECs since 1990.

The European Council's success in adopting a more stringent ETS in December 2008 on the basis of unanimity despite the global financial crisis can partly be explained by the EU's package approach. The ETS revision was negotiated in parallel with other legislative proposals, providing ample room for issue linkages, fairness in burden sharing and mutually reinforcing climate and energy goals (Skjærseth and Wettestad, 2009).

## 6. Analysis of legitimacy and stringency

With regard to participation and transparency, participation is probably, but not necessarily, positively related to stakeholder consent. Participation by non-state actors has increased in the ECCP II consultation process, which has been more open to the stakeholders' views. Moreover, participation has been enhanced to legitimize the ETS reform in other policy areas affecting, or affected by, the system. With regard to transparency, the most important change is that the actors now know much more about emissions trading as a policy instrument. With experience from the first phase based on NAPs, industry, ENGOs, member states and the Community institutions have all been able to assess the second revision phase of the EU ETS from a much better-informed perspective. In the late 1990s, only a handful of people in Europe had in-depth understanding of emissions trading. Today, emissions trading experts are found everywhere.

The correspondence between the final output and normative and popular support in the first phase is displayed in Table 1.

**Table 1: Making the EU ETS: Normative justification and support**

	Non-state actor consent			State consent	Democracy	Expertise	Final Output
	Power industry	Energy-intensive industry	ENGOs	15 member states	European Parliament	Commission and external agencies	2003 ET Directive and 2004 Linking Directive
Acceptance of ET as a good idea	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Mandatory Cap and Trade	Yes	No	Yes	Yes, majority	Yes	Yes	Yes
EU-level Cap	No	No	Yes	No	Yes	Yes	No
Auctioning	No	No	Yes	No	Yes	Yes	No, limited option
Limited access to credits from abroad	No	No	Yes	No	Yes	Yes	No

If we look at the relationship between various sources of legitimacy and the output as displayed in Table 1, we note an interesting pattern. The positions of the ENGOs and the European Parliament are in line with expert advice, but deviate from the final output. Otherwise, we see a high level of congruence between the positions of industry, member states and the final output. This suggests that the most powerful economic interests got their way. The main conclusion from this phase is that the EU ETS was based on economic interests, but only to a limited extent on ENGO and EP support and expert advice advocated by the Commission.

Our research question aimed at exploring whether increase in stringency had been based on corresponding increase in the basis of legitimacy.

**Table 2: Reforming the EU ETS: Normative justification and support**

	Non-state actor consent			State consent	Democracy	Expertise	Final Output
	Power industry	Energy-intensive industry	ENGOs	27 member states	European Parliament	Commission and external agencies	Revised ET Directive
Acceptance of ET as a good idea	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Mandatory Cap and Trade	Yes	No	Yes, more positive	Yes	Yes	Yes	Yes
EU-level Cap	Yes	No	Yes	Yes	Yes	Yes	Yes
Auctioning	Yes, majority	No	Yes	Yes	Yes	Yes	Yes, main principle
Limited access to credits from abroad	No	No	Yes	Mixed	Yes	Yes	Yes

Table 2 shows that there is a higher degree of correspondence between the final output and the positions of non-state actors, member states, the European Parliament and expert advice in the second decision-making phase compared to the first. The main deviation from this pattern is energy-intensive industry.

The first main change is that the 12 new EU member states have agreed to the revised EU ETS. These states have been fully integrated in the initiation and decision-making of the reforms unanimously adopted in the European Council, increasing the influence of the new member states on the system.

Secondly, ‘green’ organizations have become more supportive to the EU ETS, particularly to the adopted changes. The power producers supported the system in the first place, and support most of the changes. Parts of energy-intensive industry and their European federations have argued against a cap-and-trade system and are strongly opposed to auctioning.

The third major change is that the European Parliament has supported the key elements of the ETS revisions. The reason is simply that the proposed revisions were mainly in line with the initial positions of the EP in the first decision-making phase. This can also explain why the EP accepted a decision-making sequence that would formally reduce its power in relation to the member states, but increase the probability of getting the revisions adopted in time to influence the international climate negotiations in December 2009.

With regard to stringency and potential effectiveness, the 2003 ET Directive and the Linking Directive deviated from expert advice and the Commission’s initial advice with regard to auctioning, the level of the cap, and import of credits from third countries. These design flaws contributed to a malfunctioning system in the first phase. Practical experience with ignoring expert advice served to strengthen the legitimacy basis of the revisions. These revisions represent a necessary, albeit not sufficient, condition for making the EU ETS effective in the future. The revision is not sufficient, as carbon prices are affected by a range of factors other than the EU ETS, like fuel prices and the global financial crisis. The actual impact and effectiveness of the EU ETS in terms of reducing GHG emissions in Europe are as yet uncertain: it is too early to judge at this stage.

The main conclusion that can be drawn from these observations is that the legitimacy basis of the EU ETS has been broadened in line with the increase in the stringency of the system, from the first to the second phase. This indicates that lowest common denominator outcomes following from state consent have been overcome concurrent with a broader legitimacy basis, making the system more robust and as promoting compliance in the future. Whether the EU ETS is sufficiently legitimate to ensure continued widespread support is extremely difficult to say. First, it is too early to judge whether the ‘cure’ will work. Lack of effectiveness may easily undermine the legitimacy of the system in the future. Second, there are different sources of legitimacy at different governance levels, and assessing the relationship among and between them is extremely difficult. How can we compare the legitimacy of national governments rooted in free elections with the legitimacy assigned to non-state actors claiming to represent the ‘public interest’? Do countries’ positions on the EU ETS represent the public, or influential lobby groups? Is industry scepticism an expression of

legitimacy concerns, or of how well their own interests are taken into account? And what of the ENGOs' judgement of the process – does it represent a concern for non-state actors' access and participation in general, or primarily their own access and influence? These questions are important in any discussion of legitimacy, but go far beyond the space available and the ambitions of this article.

## **6. Conclusion**

The analysis of legitimacy has been based on the observation that state consent is insufficient to ensure legitimacy when decision-making power and influence are shared at several levels of government. In such cases, state consent based on a liberal intergovernmentalist understanding of EU policy-making has to be supplemented by multilevel sources of legitimacy. Our analysis shows first that the idea of emissions was imported from the USA and gradually accepted in Europe. Secondly, increase in stringency has been based on a corresponding increase in state consent, non-state participation and support, as well as support from the European Parliament and following expert advice advocated by the Commission. The multilevel mode of governance has succeeded in producing a potentially more effective system concurrent with a broader legitimacy basis.

The most significant lesson to be drawn from this case-study is that in practice multilevel governance decision-making can adopt stringent environmental policies exceeding the lowest common state and non-state denominators, without sacrificing legitimacy. In addition, the package approach where different legislative proposals are negotiated simultaneously have increase the room for compromising promoting stringency and legitimacy. That is an important lesson in light of recent EU enlargements and the global financial crisis.

The EU ETS is scheduled for operation beyond 2020. The current economic crisis has put the system under pressure, and the future will most likely bring other financial or political crises. Judged against the criteria for legitimacy applied in this article, the system appears well equipped to survive turbulent times. The next real test will be its ability to deliver significant GHG reductions. In the end, lack of effectiveness may threaten the popular support of the system. Legitimacy is easier to destroy than to build.

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