

Robust incentives and the design of a climate change governance regime

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ARTICLE INFO

Article history:

Received 2 June 2010

Accepted 28 July 2010

Available online 19 August 2010

Keywords:

Climate policy

Wind power

Incentives

ABSTRACT

In building a governance regime to address climate change, should we prioritize the development of global institutions or national ones? This paper focuses on two neglected characteristics to inform the governance problem: the incentives for investment in low-carbon energy technology and the influence of historical policy volatility. Examining a case study of an important low-carbon energy technology, wind power, this study finds: (1) policy volatility has been substantial, (2) policy changes were uncorrelated across jurisdictions, suggesting that (3) investors could have substantially reduced their exposure to the risk of policy volatility by operating globally. While it also has downsides, a poorly coordinated international policy regime has the advantage of reducing the risk associated with a global policy failure. Beyond this case study, the importance of this positive effect depends on: the probability of policy failures in each country, the correlations among them, and the probability of a global policy failure.

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1. Introduction

The design of an effective international climate governance regime requires consideration of many issues: the stringency and timing of emissions reductions; allocation of reduction responsibilities; commitments for mitigation versus adaptation; level of aid to developing countries, as well as implementation issues, such as reporting, verification, and the relative global warming potentials for greenhouse gases. Choices must address the concerns of a large number of stakeholders with heterogeneous preferences—in particular their time preferences and tolerances for risk.

A more fundamental issue is the gathering debate about whether it would be best to approach this problem by developing a set of international institutions or by leaving the bulk of important decisions to national governments. The case for a global approach relates to: the inherently global physical characteristics of the climate system, efficiencies from coordination; the urgency of implementing a response, and the need to resolve economic competitiveness concerns. The case for a national approach rests on: the ineffectiveness to date of the globally oriented approach, the tendency for international action to be limited to stringency defined by the least common denominator problem, and the formidable difficulty of satisfying radically varied priorities. The divergence in views has become more apparent with lack of progress in both domains; key national

governments have been reluctant to adopt their own targets and international agreements have not achieved resolution on any new binding commitments since 2005. Meanwhile the physical aspect of the problem appears to have deteriorated substantially as global emissions have accelerated, projections of worst case scenarios of climate damages have worsened, while best case scenarios of damages have remained stable.

1.1. Policy volatility and investment incentives

This paper seeks to add insight on the global vs. national debate by focusing on two considerations, which are typically not well characterized in policy analysis and government debates. First, the success of any agreement is inherently tied to the incentives that governments create for investors in low-carbon technologies. The long term effectiveness of climate agreements will be measured by the avoidance of climate damages, which depends centrally on investment in the development and deployment of low-carbon energy technologies (Pielke et al., 2008). These investments depend on investors' expectations of future payoffs, which depend on their expectations of governments' actions to price externalities (Nemet, 2009a).

Second, consideration of the history of government actions in this area suggests that the design of a climate regime needs to be robust to failure of the regime itself. Abundant evidence shows that government actions in the energy sector are time inconsistent—priorities change, budgets change, taxes and subsidies change; programs are cancelled, in many cases with very little warning. Governments are unpredictable and policies are

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volatile.¹ Because the payoffs to their investments depend on the details of public policy several years in the future, private-sector actors developing low-carbon energy technologies face substantial policy risk; and this may lead to underinvestment.

1.2. Governance with robust incentives

An important characteristic of policy volatility, however, is that there is wide variation in public policy across countries and even within countries. Clearly, there are efficiency gains to policy stability and international coordination. However, if stability is an elusive goal, is policy coordination still desirable? This paper examines the hypothesis that variation may actually be helpful for investment. Does the globalization of the low-carbon energy industry mean that private actors can take advantage of the heterogeneity in policy regimes? Can they, in effect, hedge their policy risk by operating in several markets simultaneously? Would a ‘bottom up’ climate policy regime, based on national policies, provide more robust incentives for innovation than a single globally negotiated agreement, such as the Kyoto Protocol? Central issues in assessment are expectations of policy failure, and the extent to which failures are correlated across countries and over time. This paper examines hypotheses related to these questions using the case of policy instruments implemented for wind power production over the past three decades.

2. International governance and investment incentives

Among many other considerations, the international response to the climate problem must accommodate three characteristics of the problem: multiple market failures, a need for massive technological change, and the longevity of requisite investments, the profitability of which depends on expectations of policy decisions several years in the future.

2.1. Needed technological change depends on government

Limiting greenhouse gas (GhG) concentrations to double pre-industrial levels would require cutting global emissions by 25–70% of business-as-usual levels by mid-century (IPCC, 2007; O’Neill et al., 2010). The investments required to accomplish the necessary transformation of the energy system are large, in the tens of trillions of dollars.² While the private sector is likely to continue to account for a dominant share of investments in innovation and deployment of new technologies, government decisions are crucial to the incentives that firms in the private sector face. Governments play a central role because market failures are prominent in this area; GhG emissions are an unpriced negative externality (Dales, 1968), new technical knowledge spills over from one firm to another (Nelson, 1959), and technology adopters have poor information relative to technology developers (Zhu and Weyant, 2003). The payoffs of firm investments in this area thus depend on the actions that governments take to remedy these public goods problems. However, since equipment in the energy sector typically lasts for decades and investments are large (Knapp, 1999), the payoffs for these

investments take many years to accrue. In the intervening years, governments can change—and the policies they implement can change. In part because of their large size and long lifetimes, investments in the energy sector are particularly vulnerable to policy volatility (Meijer et al., 2007a,b). Weakened investment incentives due to policy volatility are especially a concern in the area of climate change (Yang et al., 2008), where uncertainty in carbon prices interacts with uncertainty in fuel prices (Blyth et al., 2009).

As a result, investors in clean energy technologies seek not only strong signals, but stable ones—those with a reasonable amount of predictability over a multi-year time scale. For example, among venture capital and private equity investors, one can observe a strong preference for long term government commitments; feed-in-tariffs, in which subsidized prices are guaranteed for 10 or more years were found to be the government program most likely to stimulate investment in renewable energy (Borer and Wustenhagen, 2009). This preference for stability was also the case in the 1980s when an array of investment subsidies failed to produce large investment in wind and concentrating solar technology until 10-year procurement contracts were offered (Nemet, 2009a). The payoffs to investors in externality-improving energy technologies both rely on, and are vulnerable to, government actions.

2.2. Climate governance: organizing the response to a global problem

If government actions are needed to address public goods problems and the climate problem is a global one, how best to organize the policy response? The difficulty of forming a response is evidenced by the persistent collective action failures that have failed to produce an agreement leading to reductions in global emissions over the course of two decades of meetings, most prominently in Toronto (1988), Rio de Janeiro (1992), Berlin (1995), Kyoto (1997), Montreal (2005), and Copenhagen (2009). Not only must public goods problems be addressed, but, due to the physical scales of both the climate system and the global energy system, they occur in an international context. In summary, the challenge is to design a response to a truly global public goods problem, under deep uncertainty about future impacts—and about costs to address those impacts—with heterogeneous risk tolerance and time preferences, all over the course of several decades. It is an unprecedented challenge for global environmental governance.

One important divergence in normative approach is whether this problem is best dealt with at a global level or at a more disaggregated level; this distinction is sometimes referred to as top-down and bottom-up. The global (top-down) approach is best characterized by the United Nations Framework Convention of Climate Change (UNFCCC), which aims to secure a global agreement on targets for emissions reductions, forest protection, and aid to developing countries, among other items. Once signed, each member country designs its own implementation policies to achieve the target, ratifies the agreement on its own, and adopts it as binding domestic legislation. A key distinguishing feature is that negotiation of targets occurs at a global level and the United Nations administers the resulting agreement, even if much of the implementation details are left to the discretion of national governments. An alternative (bottom-up) is to devolve much of the decision-making, in particular selection of targets and administration, to national governments. Where there is cooperation among countries it occurs on a bilateral basis, and presumably a limited set of coordination functions, such as information collection and dissemination, would remain at a global level.

¹ In this paper, volatility refers to instability and change over time. The notion of time inconsistency captures this idea, for policy-making in general (Kydlund and Prescott, 1977) and more recently in climate policy (Helm et al., 2003).

² The International Energy Agency estimates that the investment required to address climate change will be \$11 trillion between 2010 and 2030; this amount is in addition to the \$26 trillion that will be needed to meet energy demand in the absence of concern about climate change (IEA, 2009).

The globalist approach has been criticized for several deficiencies: the large number of actors makes negotiations slow and the need for consensus leads to a lowest-common-denominator problem; international organizations are too weak to enforce an agreement so closely tied to industrial competitiveness; a single agreement cannot adequately resolve heterogeneity in national preferences; past success in globally addressing other international environmental problems, such as ozone depletion, are poor analogies to climate change (Victor et al., 2005; Prins and Rayner, 2007). On the other hand, the disaggregated approach is criticized for being too slow; unlikely to overcome free-riding; less likely to represent the concerns of the most vulnerable; lacking essential coordination mechanisms; and not making use of the institutional capacity, developed over two decades, for supporting, monitoring and enforcing an agreement (Schellnhuber, 2007; Flachsland et al., 2009; Webster et al., 2010).

3. Approach

This study seeks to add insight on the design of an international climate policy regime by assessing the links between policy volatility and investment incentives. This section describes an approach to providing quantitative insight on the following questions:

1. Were markets for clean energy technologies volatile?
2. To what extent does policy affect market size and volatility?
3. What is the resulting effect of policy on investment risk?
4. Is there an opportunity to hedge this risk?

The core of the approach to addressing these questions is to identify the role of policy in affecting market size over time and across geographies. Measures of volatility and industry concentration are then used.

3.1. Scope and case study selection

The study examines these questions for the case of a single clean energy technology, wind power. The wind power industry was selected for several reasons. First, that the technology consumes no fuel and emits no pollutants gives it public goods attributes that governments must somehow account for. Second, the industry is sufficiently well-established to provide an adequate historical record for analysis; wind turbines for electrical generation have been commercially available for three decades. Third, the technology is still dynamic so that incentives for technology development, as well as deployment, are policy relevant on their own. Fourth, while it is close to being cost competitive without government intervention, wind power still depends on government actions for widespread use. Fifth, governments have implemented a diverse set of policy instruments affecting incentives for the deployment of wind power across many jurisdictions for the life of the commercial industry. Finally, turbines, components, and related intellectual property have moved globally for three decades.³ The motivation for choosing these criteria was to enhance external validity so that the results add insight about the characteristics of expectations and incentives for other low-carbon energy technologies.

The time period analyzed is the beginning of 1981 until the end of 2008 a period that spans the emergence of a commercial

³ Some activities, such as project development, have only become international in recent years. As a result, when this study, refers to firms and the industry, it is primarily focused on the supply chain for wind turbine equipment.

Table 1
Description of variables.

Variable	Description	Units
Installations, I_{it}	Capacity of new turbines	MW
Capital investment, K_{it}	$I_{it}W_t$	\$m
Elec. consumption, C_{it}	Size of electricity market	TWh
Energy prices (1), E_{it}	Regional gas prices	\$/tcf
Energy prices (2), N_{it}	Regional gas/coal prices	\$/tcf
Wind cap. cost, W_t	Cost of installed equipment	\$/kW
Policy: exists, $P1_{it}$	Dummy for wind policy	Binary
Policy: stringent, $P2_{it}$	Dummy for stringent wind policy	Binary

market for wind power to the most recent data available. The geographic extent of the project was selected as the six countries with the highest installed wind power capacity: Germany, the U.S., Spain, India, China, and Denmark (Wiser and Bolinger, 2008). These six markets account for 75% of cumulative world installed capacity and, with the exception of the past few years, have accounted for close to 90% of the world market for new wind power turbines. Because of the size of the market and the importance of sub-national policies, the U.S. was further separated into the five states comprising the largest installed capacities in the U.S.: Texas, California, Minnesota, Oklahoma, and Iowa. As a result, this study includes analysis of 12 distinct markets for wind power: the five U.S. states, the rest of the U.S., Germany, Spain, India, China, and Denmark, and the rest of the world.

3.2. Data

To address the research questions, a panel data set of 14 geographies over 28 years is assembled for variables related to: (1) investment in new wind power capacity, (2) prices for the competing technologies, (3) energy consumption, and (4) public policy (Table 1).

3.2.1. Investment in new capacity

In each market, i in each year, t data were assembled on the megawatts (MW) of new wind turbine capacity installed (I_{it}). The annual share of installations in each country as a share of the worldwide total is shown Fig. 1. Also assembled is a time series of the prices (\$/kW of generation capacity) for installed wind turbines, W_t (Nemet, 2009b; Wiser et al., 2009).⁴ The prices for wind turbines have declined considerably over time—by more than a factor of five in this time period.

Market size is defined by capital investment in wind turbines in each country in each year ($K_{it} = I_{it}W_t$). Market size is treated as a proxy for the profitability of each market, i.e. constant returns are assumed across markets. Enhanced by a factor of 4 decline in the prices of turbines, the annual world market for wind turbines has increased to tens of billions of dollars. The global wind market in 2008 was 10 times larger than the market during the peak of the California wind boom of the mid-1980s. Note, however, that the value of turbines installed in California in 1984 remained the largest annual market in the U.S. until Texas in 2007.

⁴ A single worldwide price for wind turbine equipment is assumed. The global nature of the wind power industry supports this assumption, although unaccounted for local market dynamics, exchange rate fluctuations, and some locally produced equipment produce price differences across markets. In this study, the changes in annual installations dominate the changes in market size, such that the results are robust to price differences across countries.

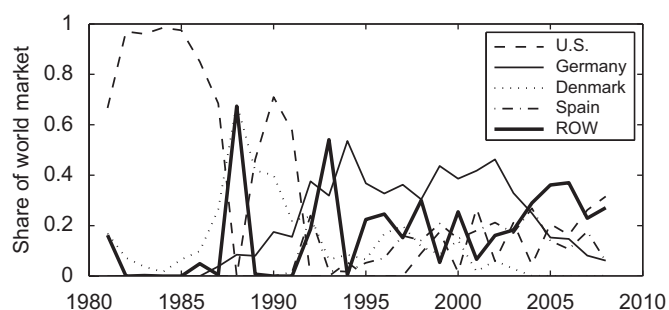


Fig. 1. Share of worldwide wind power installations by country.

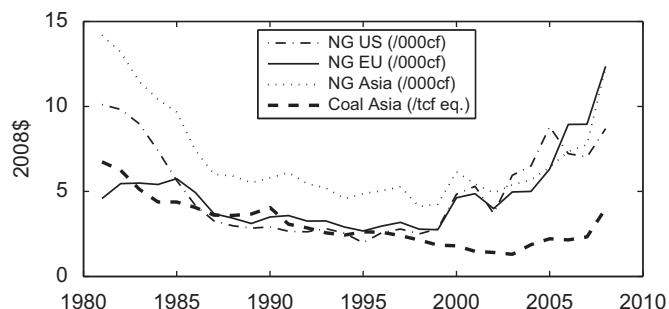


Fig. 2. Energy prices in 2008\$/000cf. Coal converted into tcf and adjusted for coal plants being 25% less efficient than natural gas plants.

3.2.2. Energy prices

A nascent energy technology like wind competes with established energy technologies that set the energy price. That price affects incentives for investment in wind (Popp, 2002). In most cases, wind power competes with the highest marginal cost energy source, which is typically electricity from the combustion of natural gas. Pricing of natural gas varies over space, as well as over time, because transportation is expensive. Average annual prices of natural gas are used for three regions (North America, Europe, and Asia) and converted into 2008 dollars per thousand cubic feet (tcf) (BP, 2009). In Asia coal prices are also used because coal use for electricity is so dominant. Coal prices are converted into equivalent physical units (tcf of natural gas) and further adjusted for the fact that coal plants are typically less efficient at producing electricity than natural gas plants (Maruyama and Eckelman, 2009; Graus and Worrell, 2009); this factor inflates the gas equivalent price of coal by a factor of 1.25. Fig. 2 shows energy prices for natural gas for three geographies as well as for Asian coal. Two panels for energy prices are assembled—one which incorporates coal prices in Asia and one which uses natural gas prices in Asia. The first (E_{it}) assigns the regional price of natural gas to locations in North America and Europe, and assigns the regional price of coal (in natural gas equivalents) to China and India. The second (N_{it}) assigns the regional price of natural gas to all locations.

3.2.3. Electricity consumption

The market opportunity for new energy technologies also depends on the size of the total potential market for energy. We proxy for this market opportunity using electricity consumption, C_{it} over time for each location in units of terawatt hours (EIA, 2009a,b).

3.3. Policy variables

To identify the effect of policy on the incentives for investment in wind power, the history of government actions related to wind

power for each location was surveyed from 1981 to 2008. Each location was coded according to whether a policy related to wind power was in place and, if so, whether any of those policies were stringent.

3.3.1. Policy history

A history of policies affecting demand for wind power was assembled for each of the six countries and five states for each year, 1980–2008. The full set of policies related to wind power was documented, including the relevant characteristics of each including: the date the policy was signed into law; the date the policy went into force; the date the policy expired; the type of instrument, e.g. capital cost subsidy, feed-in-tariff, or renewable portfolio standard; the level of any financial incentives, e.g. % tax credit, \$/kWh credit, \$/kWh tariff, % renewables required; and additional descriptive information. A detailed compilation of these policies, including the references cited, is available as Supporting Information.

3.3.2. Coding the policy history

The policy environment for wind power for each country and each year was coded for whether a policy existed and whether any existing policy was stringent. A policy was considered to “exist” if in location i at year t , a policy was in place that would have increased the market for wind power, regardless of how big an effect it was expected to have. Policy instruments that qualified included: financial incentives for producing power or installing equipment, technology mandates (such as renewables obligations), rules that enabled installation (such as ensuring independent producers grid access), and the imposition of costs on substitutes (such as eco taxes or carbon prices). We coded the variable $P1_{it} = 0$ in the absence of such a policy and 1 if any such policy was in place.

A second variable was used to code each location and year for policy stringency. Policy stringency $P2_{it} = 0$ if no stringent policies were in place, and 1 if there was at least 1 stringent policy in place. A two stage process was used to identify stringent policies. First, based on interviews with industry participants in earlier work on wind power policies (Taylor et al., 2006), the type of policy instrument described in our policy history is used to distinguish between policies that have the potential to be stringent and those which do not. For example, renewables purchase obligations, guaranteed purchase prices, and capital cost discounts have the potential to be stringent while loan guarantees, information programs, and interconnection mandates do not. The rationale for assigning policy instruments to the latter category is that while they may be helpful, and even necessary, they are not sufficient on their own to create an incentive for wind power development. Second, for those policies with the potential to be stringent, the level of each policy instrument was compared to threshold levels, which varied over time with the cost of wind power. For example, a tax credit of 1.5 c/kWh would have been considered stringent in the 2000s but would not have been considered stringent in the 1980s when wind power was much higher than the cost of the competing technology.

Finally, two analysts independently coded the policy histories according to this protocol, each producing one matrix of dummy values for existence and one for stringency. The Appendix provides a more detailed explanation of the policy coding process including the selection of threshold levels as well as the values themselves.

4. Results

The first part of this section describes the finding that the influence of policy volatility on investment incentives is large,

negative, and significant. In the second part, the data are used to assess the extent to which policy volatility can be hedged; it can be, but it relies on non-harmonized national policies.

4.1. Policy volatility has a negative effect on investment

The first claim that emerges from these results is that policy volatility has a significant effect on the incentives for investment in clean energy technologies. This claim is based on observations that: (1) policy has been volatile, (2) policy significantly affects the market opportunity, and (3) that volatile markets raise the risk of investment.

4.1.1. Volatile markets and volatile policies

The data support a fundamental premise of this research—both markets and policies have been volatile. Descriptively, one can see the effects of market volatility in Fig. 1. Market share for each location, measured as the share of the global market, has changed dramatically over time. Four different countries, the U.S., Germany, Denmark, and Spain, have at times been the largest wind power market in the world. In addition, in four years, the rest of the world, which is the sum of the markets outside the six analyzed in this study, has been larger than all of the individual large markets. The frequent changes in market share suggest that there is risk in concentrating investment in a single country.

One can also see volatility in the annual variation in market size. While Fig. 1 shows the volatility in the relative importance of each market, the growth of each market is of concern here. Using the six countries examined here, there were 130 annual growth rates between 1981 and 2008. Fig. 3 shows the distribution of those rates of change. One can see many examples of growth rates above 1 (100%), where markets more than doubled from one year to the next. Conversely, one also sees many instances of growth rates of -1 , that is, where a market ceases to exist in a given year.⁵ Table 2 provides descriptive statistics about these annual changes. An important characteristic of these data is that the standard deviation across the individual markets is substantially larger than that of the world taken as a single market. Volatility—calculated as standard deviation divided by the mean—is substantially larger for the individual markets. One can see this graphically in the flatter distribution of the individual markets (in black) compared to the world market (in white).

Policies in the large wind power markets have also been volatile. One can see this directly in the policy coding shown in the electronic Supporting Information. Implementation of wind power policies emerged in different times—as early as 1981 in three countries and three U.S. states, and as late as the mid-1990s in others. The implementation of stringent policies occurs later. Of central interest for this study, there were several instances in which a government implemented stringent policies and then eliminated them. For example, two years after introducing them, California cancelled its generous contracts for guaranteed purchase prices with little warning in the fall of 1985. The federal U.S. production tax credit has been allowed to expire three separate times in the 2000s. Note that collapsing a rich set of policies into a binary variable makes this measure a lower bound on policy volatility. It masks variation in the intensity of policies coded as stringent and does not count as a policy change cases in which one stringent policy was replaced with another.

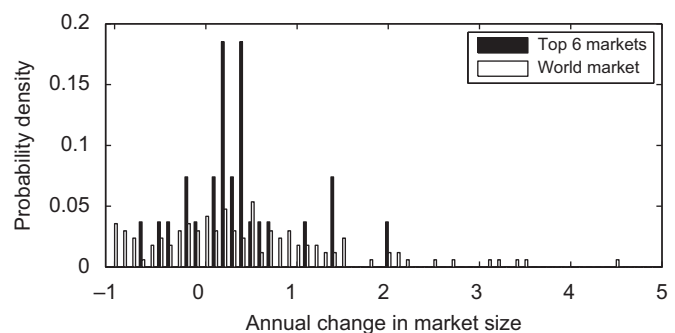


Fig. 3. Probability density for annual change in market size. Black indicates six largest markets. White includes the entire world as one market.

Table 2

Annual change in market size.

	World aggregated	6 countries	6 states, 5 countries
Mean	0.40	0.76	0.90
Median	0.32	0.35	0.34
Std. dev.	0.60	1.74	2.31
Volatility	1.51	2.29	2.56
<i>n</i>	27	130	174

4.1.2. Policy affects market size

Not only are both markets and policies volatile, but they are also linked. This section finds that policies have a significant effect on market size. The panel data described above are used to test the significance of variables for policy existence and policy stringency as determinants of the size of wind power markets. The estimation approach is as follows. Policy and control variables are regressed on two indicators of investment in wind power technology. The first dependent variable used is megawatts of new wind power capacity, I_{it} . This measures actual deployment of the technology, not accounting for changes in prices, but primarily focused on the social goal, which is deployment of wind power technology. The second dependent variable is annual investment in wind power in each location, K_{it} . This variable represents a direct measure of investment and as such an indicator of the effect on incentives, rather than on deployment of the technology itself. The effect of policy is identified using two binary variables: one for the existence of any wind power policy $P1_{it}$ and another for the existence of stringent wind power policy, $P2_{it}$. The two are additive so both dummies are included simultaneously. The three possible combinations for $(P1, P2)$ are: (1,0), (1,1), and (0,0).

Controls are added for energy prices, electricity consumption, and the cost of wind power. The strategy employed here is to control for two non-policy influences on investment incentives: (1) the size of the market potential C_{it} , and (2) the relative cost of wind power, W_t and the competing technology—gas or coal (E_{it} and N_{it}). The hypothesis is that the cost of wind power should have a negative effect on investment and that energy prices should have a positive effect. Table 3 shows descriptive statistics for the dependent and independent variables used in the regression. For estimation, all ratio variables are logged.

Table 4 shows the results from regressing policy variables and controls on wind power investment. The table shows results for both random (1, 2, and 3) and fixed effects (4, 5, and 6) models. First, three versions of a random effects model are estimated: (1) an initial version using investment as the dependent variable and an energy price variable that uses coal in Asia, (2) a similar version that uses the price of natural gas in Asia, and (3) a version

⁵ Note that these results do not depend on high rates of growth attributable to a very small base year; growth rates are as high in the 2000s as in the 1980s.

of model 2 that uses installed capacity rather than dollars of investment as the dependent variable. The coefficients for the independent variables are all significant and with signs as expected. These results are robust to whether coal or gas prices are used and to whether dollars or megawatts of installations is used as a dependent variable. Both policy indicators are significant determinants of investment; but the effect of having stringent policy is a factor of 2–2.5 more influential than having any policy at all. Because the policy variables are additive, the total effect of having stringent policy is > 3 times the effect of having policy that is not stringent. The residuals are not correlated with any variables or with their lags.

Second, fixed effects models are used to isolate the effects of the variables within each geography over time. The variables used in fixed effects models 4–6 correspond to those used in the random effects models 1–3. As expected, goodness of fit is substantially less and significance slightly reduced. The biggest change from the random effects model is that the coefficients on market size (electricity consumption) are larger. Otherwise, the coefficient results are similar to what was found in the random effects model; policy is significant and stringent policy has a stronger effect. Most important, the variables remain significant, and coefficient signs as well as size are stable. That the results are similar in the fixed effects model allays concerns of possible bias in the random effects models.

These results show that policy significantly affects investment. Further, since Section 4.1.1 indicates that both policy and markets

have been volatile, investors face a real concern that policy volatility makes investment risky.

4.2. Operating globally reduces policy risk

If policy volatility makes investment risky, is it possible to hedge that risk? The second main claim that emerges from these data is that a hedge against policy risk is available because policies across locations are decided independently. Policies are not well correlated, in part because a diverse set of motivations exists for implementing policies that favor wind power. Investing globally reduces policy risk. However, an important caveat is that the value of globalization as a hedge against policy volatility depends on the independence of policies; policy harmonization would lessen the value of this hedge and may expose investments to greater risk.

4.2.1. Policies and markets are uncorrelated across geography

Policy volatility is hedgeable because policies related to wind power are uncorrelated. The regression results in Section 4.1.2 showed that policies affect market size. One can observe the results of this lack of policy correlation in Fig. 4, which shows annual growth rates for each location over time. Note that every single year from 1981 to 2008 includes locations in which the market was larger than the previous year and that every year also includes locations in which the market was smaller than the

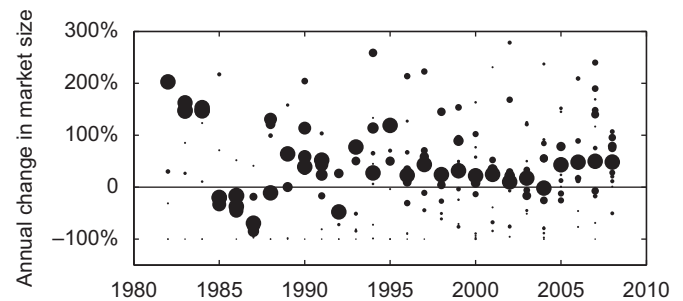


Fig. 4. Annual growth rates for all markets. Size of circles indicates annual share of market for new installations. Note that all years include negative rates of growth and that even large markets show large changes in annual growth.

Table 3
Descriptive statistics for dependent and independent variables.

Variable	<i>n</i>	Mean	Std. dev.	Min.	Max.	Units
Installations, I_{it}	308	297	718	0	6160	MW
Cap. investment, K_{it}	308	492	1230	0	11,796	08\$m
Elec. consump., C_{it}	308	467	749	22	3166	TW h
Energy prices 1, E_{it}	308	4.57	2.39	1.30	12.36	\$08/tcf
Energy prices 2, N_{it}	308	5.28	2.64	1.98	14.19	\$08/tcf
Wind cap. cost, W_t	308	2213	1021	1340	5652	08\$/kW
Policy: exists, $P1_{it}$	308	0.85	0.35	0.00	1.00	Binary
Policy: stringent, $P2_{it}$	308	0.43	0.50	0.00	1.00	Binary

Table 4
Coefficient estimates for six models.

	Random effects			Fixed effects		
	(1)	(2)	(3)	(4)	(5)	(6)
Dependent variable	$\ln(I_{it})$	$\ln(I_{it})$	$\ln(K_{it})$	$\ln(I_{it})$	$\ln(I_{it})$	$\ln(K_{it})$
Independent variables						
Elec. consumption, C_{it}	0.57 (4.93)	0.43 (3.84)	0.48 (3.72)	2.30 (5.80)	2.01 (4.97)	2.19 (4.83)
Energy prices (1), E_{it}	1.68 (6.52)	0.00 (0.00)	0.00 (0.00)	1.84 (7.20)	0.00 (0.00)	0.00 (0.00)
Energy prices (2), N_{it}	0.00 (0.00)	1.83 (6.92)	1.86 (6.27)	0.00 (0.00)	1.79 (6.76)	1.82 (6.13)
Wind cap. cost, W_t	-2.48 (-5.90)	-2.67 (-6.29)	-2.38 (-4.99)	-1.83 (-4.15)	-2.03 (-4.40)	-1.70 (-3.28)
Policy: exists, $P1_{it}$	1.12 (3.60)	1.23 (3.96)	1.42 (4.06)	1.05 (3.11)	0.92 (2.73)	1.10 (2.92)
Policy: stringent, $P2_{it}$	2.91 (12.28)	2.77 (11.48)	2.94 (10.85)	2.29 (8.90)	2.28 (8.72)	2.39 (8.13)
Summary statistics						
R^2	0.665	0.682	0.650	0.381	0.407	0.376
<i>n</i>	308	308	308	308	308	308
Geographies	11	11	11	11	11	11

T ratios are in parentheses below coefficients.

previous year. Even large markets show large changes in annual growth; growth rates for the two most important national wind power markets over this period, Germany and the U.S., have a correlation coefficient of -0.057 . This paper does not seek to explain the reasons that countries and states decide to enact policies relevant to wind power, but it seems clear that the motivations for doing so are diverse.

4.2.2. Hedging policy risk

Because markets are not correlated, operating globally provides a hedge against volatility. This opportunity to hedge policy risk can be observed in two ways. First, as seen in Fig. 3 and Table 2, the volatility in the market growth is substantially smaller when considering the world as a single market (volatility=1.51) rather than viewing the six largest countries as individual markets (volatility=2.29). An investor operating globally would face a volatility of 1.51 while an investor operating in a single country would face a higher level of volatility, as characterized by the 2.29 value across all large markets. Including the individual states would raise volatility even higher to 2.56.

Second, one can compare two investment strategies. A wind power investor who maintained a market share of 10% of the world wind power market from 1981 to 2008 would generate revenues of just under \$20b (converted to 2008 dollars but not discounted). An equivalent revenue could have been obtained with a 44% constant share of the U.S. market. Given equivalent mean annual revenues of \$713m, standard deviation for the world market was \$1189 while that for the U.S. was \$1518. Put another way, concentration in the U.S. market would generate five years with zero revenues, while there were no years in which a 10% share of the world market produced no revenues.

4.2.3. Evidence of a global and less concentrated industry

Given the apparent opportunity to hedge policy risk, the data show that: (1) firms are taking advantage of this hedge and (2) the reduced concentration of the industry is making this hedge more viable. International trade in wind turbines has been large for three decades. In the 1980s, when California accounted for more than 90% of the world wind market, imported turbines accounted for 45% of new capacity in 1985, the peak year of the 1980s, and 75% in 1986 (WPRS, 1986). International trade continues to be important in more recent years. For the top-10 wind markets, 60% of the turbines installed in 2006 were imported from another country—an increase from 46% in 2005 (Lewis and Wiser, 2007; Lewis, 2007). Denmark, home to the world's largest turbine company (Vestas) has exported 91% of the 30 GW of turbines manufactured there between 1996 and 2006. China's domestic industry has grown rapidly, but still 42% of their new installations in 2007 were imported. The growth of China's share of its domestic market does not reduce the importance of trade; China's producers are heavily involved in export markets and foreign technology continues to be imported to China. Note though that globalization is most pronounced in wind power equipment; project development has only become international in recent years, suggesting that some parts of the supply chain are more amenable to international trade than others, despite apparent benefits for all parts.

Reduced concentration and the emergence of multiple large markets have increased the feasibility of using this hedge. Wind power installations have been less geographically concentrated over time so that no single market dominates the industry. Calculating the Hirschman–Herfindahl index for these data shows that market concentration has decreased over time (Fig. 5) (Hirschman, 1964). The trend in, and the level of, the index value is insensitive to the universe of markets used to define the index; whether using the top six countries, including the largest five states, or including all 76 countries in which some wind power installed, turbine installations

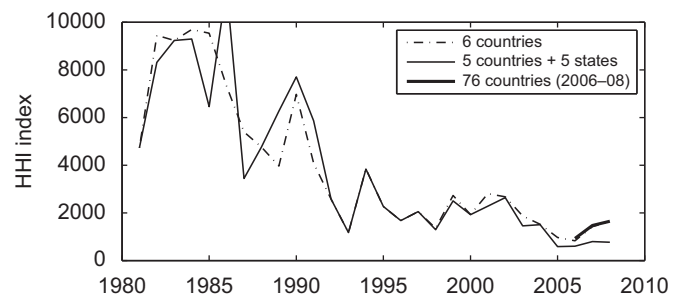


Fig. 5. Concentration index (higher HHI score indicates higher concentration).

have become less geographically concentrated. Consequently the wind turbine supply chain has become less vulnerable to policy changes in any single location.

An important limitation on this hedging possibility is that it hinges on policies being independent across locations. A mechanism that would tend to reduce independence would also reduce the value of the hedge. While there are certainly benefits to harmonization, as the following section discusses, it also introduces risk that is difficult to avoid.

5. Implications for climate governance

The magnitude of the required changes in the energy system to meaningfully address climate change makes the incentives for technology development and deployment a central concern. The preferences of investors for stable and growing returns conflict with the history of energy policy, which is prone to rapid changes and reversals. The data on wind power show that firms could have substantially reduced their risk by operating globally, so that they could take advantage of uncorrelated policy changes. The globalization in the wind power industry, even from early on is in part attributable to firms taking advantage of this opportunity to hedge policy risk. The availability of this hedging opportunity in the future depends on policy decisions that are uncorrelated. Yet much of the effort on climate change governance has been oriented around implementing a more harmonized global approach to addressing the problem.

Implications for climate governance are subject to the obvious caveat that this study has looked at a single historical case, whereas transformation of the energy system to address climate change will involve many technologies. However, several characteristics of this case study make it more likely to underestimate the effect of expectations about government actions, than to overestimate them. Wind is a mature technology that is now close to cost competitive even without government-provided incentives. The scope of technological change needed to address climate change will necessarily involve technologies that are less mature, require more development investment, involve more technological risk, and are thus *more* sensitive to expectations about future government actions.

5.1. Consideration of other factors

If a goal is to create strong incentives for technology investment, would we be better off with a set of uncorrelated national and sub-national policies or with a harmonized global regime? As described above, strong claims have been made on both sides of the debate (Victor et al., 2005; Prins and Rayner, 2007; Schellnhuber, 2007). The evidence in this particular case suggests we pay close attention to the stability of incentives with a harmonized global solution. More generally, design of a climate

regime that optimizes incentives for technology investment depends primarily on three variables:

- the probability that any government will cancel its policy,
- the correlation of policy changes with each other, and
- the probability that a harmonized global agreement will fail, in effect canceling policies globally.

The effects of a global collapse of a climate agreement occurring would be devastating to technology markets; climate-related incentives would fall to zero, and incentives would depend on valuing the non-climate benefits of the technology (Nemet et al., 2010). One could imagine technology developers populating a model that optimizes returns based on these three parameters. The greater the chances of national policy changes, relative to a global change, the more likely the world would be better off with a global regime that limits the discretion of national governments to change their policies. However, the benefits of a global regime decrease with decreasing correlation among national policies; the less correlated national policies are, the more viable it becomes to hedge national policy risk by investing simultaneously in multiple markets. Low correlations can offset high probabilities of national policy changes. Still, avoiding national policy collapse completely is better than hedging some of it. The world would be better off with a harmonized global regime unless there is some possibility that regime itself is vulnerable to policy volatility. The apparent failure, at the 15th Conference of the Parties to the UNFCCC in Copenhagen in late 2009, to extend and expand an existing global agreement supports the notion that the risk of a global collapse is non-negligible. The possibility that a harmonized global regime may collapse, even if it is well-designed, is what makes the model of disparate national policy mechanisms attractive. An important caveat with this strategy is that correlation values need to be much less than unity. A bottom-up approach to climate policy that is universally sensitive to the same roll-back mechanisms as a global agreement is not superior to a global one.

Additional variables would enhance development of this type of model. For example, the benefits of reduced transactions costs from uniform policy would influence choice in the opposite direction of the hedging value. Further, estimates of fixed political or economic costs associated with national and global efforts would enable assessment of the feasibility of a hybrid strategy, in which both are pursued simultaneously. Also, one could argue that the levels of national policy stringency may be endogenous to the amount of correlation among them. For example, coordinated policies encourage willingness to pursue more ambitious targets by allaying competitiveness concerns. Conversely, they may lead to less ambitious targets due to lowest common denominator problems inherent in global negotiations. A more explicit discussion of these parameters would help inform debates about the optimal design of climate policy, from a technology development perspective. Work that estimates values would benefit debates as well. Finally, examination of incentives for the development of other low-carbon technologies would help assess the external validity of the results for wind power for low-carbon energy technologies in general. The extent of globalization of an industry seems of particular importance.

5.2. Persistent drivers of policy volatility

Climate policy design that assumes monotonically increasing stringency conflicts with historical experience of related policies over the past three decades. Volatility in energy policy is attributable to a diverse set of factors: rapid changes in energy prices due to supply shocks and demand shocks; emergent geo-political threats associated with access to energy; focusing events that raise the

immediacy of perceived environmental problems; the electoral cycle, which both creates and limits opportunities for implementing policies; issue fatigue associated with portraying long term energy challenges as crises; the business cycle and associated concerns about employment and economic growth; and changes in the urgency of competing social priorities, such as military conflicts, finance, health care, and education. Given the persistence of these factors, it would be socially risky to consider policy volatility a historical aberration from which we have learned. Meanwhile, the physical characteristics of both the climate and energy systems mean that problems will not be solved quickly, even if we make unprecedented and successful efforts to initiate a meaningful response. As a result, there will always be competing social concerns at stake—and always an option of adjusting climate-related commitments. Given the inherently long time horizons required, policy needs to be robust to both the risk of a collapse of an international deal and the risk of correlated national policies in a bottom up framework. This situation implies that we should pursue national and international governance independently—not because we want to see which is more effective—but rather because we need to protect those with large investments at stake from the inevitability of changes in the relative importance of competing social concerns. A crucial consideration for this hybrid strategy is whether the fixed costs of each make simultaneous engagement in both prohibitively expensive. Another interpretation is that complementary policies, such as technology-oriented policies (Galiana and Green, 2009) and agreements (de Coninck et al., 2008), may be needed to make up for incentives that are reduced due to policy risk.

5.3. Conclusion

The heterogeneity of public policies affecting wind power has provided an effective way for private sector innovators to reduce their exposure to the substantial policy risk resulting from chronic policy volatility. Similarly, the development of a global regime for reducing emissions of greenhouse gases holds the promise of enlarging the market for new technologies and enhancing the incentives for deployment of needed low-carbon technologies. However, the consolidation of the bulk of important decisions in a single supra-national institution limits the ability of firms to hedge policy risk by entering multiple markets. Optimal policy design depends on valuations of policy volatility, correlation of policy changes, and the probability of collapse of a global regime. A harmonized global climate regime may be more efficient; but it could simultaneously be more risky.

Acknowledgments

I thank Paul Ferguson for research assistance and the La Follette School of Public Affairs at the University of Wisconsin for research support. Reviewers provided very helpful suggestions. This work was informed by discussions in the Governing Global Energy Collaborative sponsored by the Center for World Affairs and the Global Economy (WAGE) at the University of Wisconsin-Madison.

Appendix A. Coding policies

This appendix describes the methodology used to code the existence and stringency of wind power policies in each year and geography. Details about the policies themselves are available as online Supporting Information.

A.1. Policy existence

The main text describes the simple criteria used to identify whether a wind power policy was in place in each country and year. The value for $P1_{it}$ was coded as 1 if a policy was in place that had the effect of increasing demand for wind power in that location and time. An observation was coded as 1 regardless of the strength of the effect.

A.2. Policy stringency

Each location's policy environment was coded for its stringency ($P2_{it}$); 0 = not stringent, 1 = stringent. Coding for stringency involved the following: First, two categories of policies were defined based on their importance in affecting demand for wind power. The items within these categories were determined from interviews and analyses in Taylor et al. (2006) and Nemet (2009a), in which certain types of policies were found to be inherently more stringent than others. The following policy instruments have the potential to be coded as stringent:

- Purchase obligations: quantity based targets that require some entity—government agencies, electric utilities, companies—to buy a specified amount of wind or renewable power. A common example is state renewable portfolio standards (RPS).
- Guaranteed tariffs: agreements in which governments guarantee revenues to a wind power producer at a premium (e.g. \$/kWh) above the market electricity price for a pre-specified period of time. Sometimes referred to as “feed-in-tariffs”, examples include programs in Spain and Germany in the 2000s and in California (SO#4) in the 1980s.
- Capital cost subsidies: governments offer to pay a specified portion of the capital cost of a wind power project. Payment is provided to the wind power producer as a tax credit or in the form of a direct payment as a rebate. Examples include the Danish Wind Turbine Reimbursement program and the U.S. Federal Investment tax credit, in the 1980s.
- Performance incentives: government provides a subsidy to the power producer based on the amount of electricity they produce, either as a tax credit or as a direct payment. See for example the U.S. Production Tax Credit, which began in the 1990s.

In contrast, other policy instruments were considered inherently non-stringent because on their own they were insufficient to generate a substantial increase in demand for wind power. These include: loan discounts, loan guarantees, information programs, interconnection agreements, mandates that utilities buy from independent generators, renewable energy certificate programs, and policies that are limited to small wind power projects.

Second, for those policy instruments categorized as having the potential to be stringent, threshold levels were calculated for each type of policy.

- Purchase obligations: any level of mandated purchases qualifies as stringent. While a trivially small mandate would not be stringent, we did not find any such examples in our policy survey.
- Guaranteed tariffs: the threshold is calculated as the difference between the unsubsidized cost of wind power and the price of competing power generation technologies, assumed to be stable at 4 c/kWh. These calculations imply approximate price thresholds of 10 c/kWh in the 1980s, 3 c/kWh in the 1990s and 1 c/kWh in the 2000s.
- Capital cost subsidies: similarly, the threshold for stringency for

capital cost discounts declined over time as the unsubsidized cost of wind power declined. Subsidies required to qualify as stringent are 1980s: $\geq 50\%$, 1990s: $\geq 30\%$, 2000s: $\geq 25\%$.

- Performance incentives: the same threshold levels is used as described in capital cost subsidies.

A.3. Coding results

Using this protocol, two analysts independently coded the policy histories, each producing two 12×28 matrices of ones and zeroes. The two analysts agreed on 95.5% of the cells for policy existence ($n=308$) and 93.2% of the cells for policy stringency ($n=308$). The majority of conflict cases involved feed-in-tariffs with rates that were close to the threshold level. Conflicting cells were then resolved by reading the policy history documentation and re-interpreting the stringency and existence of the policies with conflicting interpretations.

Appendix B. Supplementary data

Supplementary data associated with this article can be found in the online version at doi:10.1016/j.enpol.2010.07.052.

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