Mitigation Strategies and Costs of Climate Protection: The effects of ETC in the hybrid Model MIND

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NOTA DI LAVORO 150.2005

DECEMBER 2005

CCMP – Climate Change Modelling and Policy

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This paper is one of a series published by FEEM on the theme of innovation modeling in the context of the challenge of stabilising atmospheric concentrations of greenhouse gases, as part of the Innovation Modeling Comparison Project. This is an international project launched and overseen by the Steering Committee of the informal International Programme on the Economics of Atmospheric Stabilisation.* The broad aim of the collaboration is to advance understanding of the economic issues surrounding atmospheric stabilisation, and the specific aims of the IMCP are to provide insights into the "state of the art" and implications of endogenous modeling of technical change in global energy-environment models when applied to various levels of atmospheric stabilisation.

Members of the Steering Committee provided review comments on earlier drafts and the paper has been forwarded to external review, the final results will be published as a Special Issue of the Energy Journal. The papers have all been encouraged to draw on a common baseline (the "Common Poles-Image baseline") and to report results in comparable formats, so as to facilitate intercomparison of the different modeling results. All the results and judgements expressed here remain the responsibility of the authors.

The work presented here was funded by the Volkswagen Foundation, Project II/78470, which the authors gratefully acknowledge. FEEM fund the working papers series, and seed money for the coordination work of the Innovation Modeling Comparison Project was provided by UK Department of Environment, Food and Rural Affairs and the German Ministry of Environment.

The authors are also grateful to Elmar Kriegler for productive discussions and helpful comments on an earlier version of this paper.

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Summary

MIND is a hybrid model incorporating several energy related sectors in an endogenous growth model of the world economy. This model structure allows a better understanding of the linkages between the energy sectors and the macro-economic environment. We perform a sensitivity analysis and parameter studies to improve the understanding of the economic mechanisms underlying opportunity costs and the optimal mix of mitigation options. Parameters representing technological change that permeates the entire economy have a strong impact on both the opportunity costs of climate protection and on the optimal mitigation strategies, e.g. parameters in the macro-economic environment and in the extraction sector. Sector-specific energy technology parameters change the portfolio of mitigation options but have only modest effects on opportunity costs, e.g. learning rate of the renewable energy technologies. We conclude that feedback loops between the macro-economy and the energy sectors are crucial for the determination of opportunity costs and mitigation strategies.

Keywords: Endogenous technological change, Climate change mitigation costs, Integrated assessment, Growth model, Energy sector, Integrated assessment

JEL Classification: O41, Q40, Q43, Q55, C61, D99

We are grateful to Elmar Kriegler for productive discussions and helpful comments on earlier version of this paper. This work was funded by the Volkswagen Foundation, Project II/78470, which we gratefully acknowledge.

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1. Setting the Scene

The Innovation Modeling Comparison Project (IMCP) explores the consequences of endogenous technological change (ETC) for the economics of stabilizing atmospheric carbon dioxide (CO_2) concentration. This paper contributes to the IMCP by presenting an analysis of technological change at different levels and in different sectors in the Model of Investment and technological Development (MIND). MIND combines an intertemporal endogenous growth model of the macro-economy with sector-specific and technological details taken from the field of energy system modeling. In particular, we explore the impact of endogenous technological change on opportunity costs and mitigation strategies in the framework of a social cost-effectiveness analysis.

We explore the impact of ETC in a social cost-effectiveness framework because we want to understand how technological change is induced by climate policy. Several studies have already incorporated aspects of ETC in this framework (Buonanno et. al. 2003, Chakravorty et. al. 1997, Goulder and Mathai 2002, Kypreos and Barreto 2000, Nordhaus and Boyer 2000, Nordhaus 2002, Popp 2004a, 2004b). The added value of MIND arises mainly from two features: First, we incorporate a wide spectrum of relevant mitigation options at least at a highly aggregate level. MIND incorporates improvement of energy efficiency, carbon capture and sequestration (CCS), renewable energy technologies, and traditional non-fossil fuels (large hydropower and nuclear). Second, technological change in MIND has an endogenous formulation with R&D investments in labor and energy productivity, learning-by-doing, and vintage capital in the different energy sectors. We believe that including these features of ETC is essential for the assessment of macro-economic mitigation costs and the portfolio of mitigation options. MIND is a hybrid model merging features from bottom-up models and top-down models. It resembles a bottom-up model because it comprises several energy sectors. However, the technologies are represented at a more aggregated level than in energy system models. We have embedded these sectors within a macro-economic environment in order to evaluate the feedbacks between the macro-economy and the energy sector (for another example of such an exercise, see Manne et. al. 1995). We will show that these feedbacks are crucial for an understanding of opportunity costs and mitigation strategies in an economy faced with climate policy.

The next section briefly introduces the model and its calibration, highlighting the improved treatment of CCS in MIND 1.1. The main part of this paper is the discussion of technological change within MIND in section 3. Section 4 concludes.

2. The model structure of MIND 1.1

The model equations of MIND are introduced and discussed in Edenhofer, Bauer and Kriegler (2005). The model version 1.0 presented therein has been extended by Bauer (2005). In his work, Bauer replaces exogenous scenarios of Carbon Capture and Sequestration (CCS) with a technologically detailed, endogenous treatment of the CCS option (model version 1.1). This study uses MIND 1.1, slightly adjusted to meet the requirements of the IMCP and enhanced by a more sophisticated carbon cycle (Hoos et al. 2001). The following section provides a summary of the model structure and parameter calibrations. Model equations are restricted to the parameters treated in the sensitivity analyzes and parameter studies in this article; for a comprehensive discussion of the model structure we refer to Edenhofer et al. (2005) and Bauer (2005).

MIND is an integrated assessment model comprising a model of the world economy with particular attention paid to the energy sector, and a climate module computing global mean temperature changes. MIND therefore allows us to assess the impacts of constraints to climatic change on the economy in cost-effectiveness analyzes.

MIND models economic dynamics by adopting an endogenous growth framework. It calculates time paths of investment and consumption decisions that are intertemporally optimal. The objective is to maximize social welfare, which is defined as the present value of utility (pure rate of time preferences is 1 %), which is a function of per capita consumption exhibiting diminishing marginal utility. Most economic activity is subsumed in an aggregate CES production function (equation 1), the output Y_A of which describes the gross world product (GWP).[1]

$$Y_A = \Phi_A \left[\xi_A^L \left(A * L_A \right)^{-\rho_A} + \xi_A^E \left(B * E \right)^{-\rho_A} + \xi_A^K K_A^{-\rho_A} \right]^{-1/\rho_A} \qquad (1)$$

The income share related parameters ξ_A are calibrated so that the actual income shares of labor L_A, energy E, and capital K_A relate to each other as 66:4:30. Total factor productivity Φ_A is a fixed scalar calibrated to such a value that historical output of 2000 is reproduced. The elasticity parameter ρ_A determines the elasticity of substitution $\sigma_A = (1+\rho_A)^{-1}$. In some integrated assessment models, the elasticity of substitution between capital and energy is 0.4 for developed countries and 0.3 for developing countries (Manne et al. 1995). We have chosen an overall elasticity of substitution for all three factors of $\sigma_A = 0.4$. Labor L_A is described by an exogenous population scenario adopted from the common POLES/IMAGE baseline (CPI, Vuuren et al. 2003), and the capital stock K_A is built up through investments and depreciates at a rate of 5 %. The initial value of K_A is derived from Y_A and an estimated capital coefficient. Capital coefficients computed from the OECD database and from PWT6.1 for different countries cluster around 2.5. Since energy sector capital is separate from K_A, we assume a lower capital coefficient of 2.0. Variables A and B denote the productivities of labor and energy, respectively, and are stock variables determined by R&D investments according to equation (2):

$$\frac{\dot{A}}{A} = \alpha_A \left(\frac{RD_A}{Y} \right)^{\gamma_A}, \qquad with\ A\left(t = \tau_1\right) = A_0 \qquad (2)$$

$$\frac{\dot{B}}{B} = \alpha_B \left(\frac{RD_B}{Y} \right)^{\gamma_B}, \qquad with\ B\left(t = \tau_1\right) = B_0 \qquad (3)$$

RD_A and RD_B are investment flows controlled by the central planner. The role of parameters γ_A and γ_B is to decrease marginal productivity of R&D investments, which happens for values lower than unity. They are set to 0.05 and 0.1, respectively. Parameters α_A and α_B determine the productivity of R&D

[1] MIND is implemented in discrete time steps of 5 years. In the model equations of this text we present the more intuitive continuous formulations, e.g. in case of derivatives.

investment. They are calibrated at such a rate that spending 1% of the GWP on energy R&D increases the energy efficiency parameter by 2.25%; when 2.5% of GWP is spent on labor R&D, the labor efficiency parameter increases by 2%.

The energy input to aggregate production, *E*, is an additive composite of fossil energy, renewable energy, and traditional non-fossil energy, the latter given exogenously. Fossil energy is produced from energy conversion capital and primary energy input in a CES production function. Fossil resources are converted to primary energy using an exogenous assumption about the carbon/energy ratio of the fossil fuel mix, its availability being described by a model of resource extraction. Resource *R* is extracted by capital K_{res}, the average productivity of which is subject to a scarcity effect ($\kappa_{res,s}$) and a learning-by-doing effect ($\kappa_{res,l}$):

$$R = \kappa_{res} K_{res} \tag{4}$$

$$\kappa_{res} = \kappa_{res,s} \kappa_{res,l} \tag{5}$$

The initial resource extraction is R = 6.4 GtC (SRES), assumed to be produced by a capital stock of K_{res} = 5 trillion \$US. This determines $\kappa_{res,l}$ because $\kappa_{res,s}$ is normalized to unity.

The scarcity effect $\kappa_{res,s}$ is determined by the marginal costs of resource extraction C_{res}^{mar} :

$$\kappa_{res,s} = \frac{\chi_1}{C_{res}^{mar}} \tag{6}$$

In equation 6, parameter χ_1 as well as the marginal costs in 2000 are set to \$113. During the simulation, marginal costs C_{res}^{mar} increase with cumulative resource extraction CR_{res} according to equations 7 and 8.

$$C_{res}^{mar} = \chi_1 + \chi_2 \left(\frac{CR_{res}}{\chi_3} \right)^{\chi_4} \tag{7}$$

$$CR_{res}(t) = \int_{\tau_1}^{t} R(t')\,dt', \quad with\ CR_{res}(t = \tau_1) = 0 \tag{8}$$

Parameter χ_1 denotes initial costs of the fossil resource, the exponent χ_4 controls the curvature of the function, i.e. the timing of increasing costs, χ_2 gives the marginal costs once the amount described by χ_3 has been extracted. We parameterize this function in accordance with Rogner's (1997) empirical assessment of world hydrocarbon resources arriving at the values χ_2 = 700, χ_3 = 3500 and χ_4 = 2.

The learning-by-doing effect of capital productivity $\kappa_{res,l}$ depends on the ratio of actual resource extraction $E_{res,l}$ to initial resource extraction $E_{res,l}^{0}$.

$$\dot{\kappa}_{res,l} = \frac{\kappa_{res,l}}{\tau_{res,l}\kappa_{res,l}^{max}}\left(\kappa_{res,l}^{max} - \kappa_{res,l}\right)\left(\left(\frac{E_{res,l}}{E_{res.l}^{0}}\right)^{\beta_{res,l}} - 1\right) \tag{9}$$

with $\kappa_{res,l}(t=\tau_1) = \kappa_{res,l}^{0}$

The factor $\beta_{res,l} = 0.4$ dampens the learning-by-doing effect: a rapid increase in extraction induces a loss in productivity gains relative to the same increase in extraction spread over a longer time period. Furthermore, productivity gains from learning saturate when productivity approaches its maximum value $\kappa_{res,l}^{\max}$ which is set to twice its initial value. Parameter $\tau_{res,l}$ determines the speed of learning and is set to 100 years.

Renewable energy E_{ren} is produced by capital Kap_{ren} which is employed at FLH_{ren} = 2190 full load hours per year.

$$E_{ren}(t) = FLH_{ren} * Kap_{ren}(t) \tag{10}$$

$$Kap_{ren}(t) = \int_{t_0}^{t} \omega(t-t')\kappa_{ren}(t')I_{ren}(t')dt' \tag{11}$$

The available renewable energy capital stock in each point in time is determined by summing over the investments into renewable energy I_{ren} in preceding time steps multiplied with the productivity of installed capital κ_{ren}. Depreciation is modeled by weights ω which determine the fraction of capital that still remains, ω_1 to ω_7 are set to 1.0, 0.9, 0.8, 0.7, 0.5, 0.15, 0.05, and $\omega_i = 0$ if $i > 7$. This allows to model different capital productivities for different vintages of the capital stock. Capital productivity κ_{ren} indeed changes in time because the costs of renewable energy equipment c_{ren} decrease, subject to learning-by-doing.

$$\kappa_{ren} = \frac{1}{c_{ren}(t') + c_{floor}} \tag{12}$$

The inverse of floor costs $c_{floor} = 500$ US$/kW constrains capital productivity from above, while c_{ren} starts out at $c_{ren,0} = 700$ US$/kW and decreases with cumulative installed capital $CKap_{ren}$:

$$CKap_{ren} = \int_{\tau_0}^{t} Kap_{ren}(t')dt' \tag{13}$$

The following equation describes the dynamics of learning-by-doing in the renewable sector:

$$c_{ren,t} - c_{ren,t-1} = c_{ren,0} CKap_{ren,0}^{\mu_{ren}} (CKap_{ren,t}^{-\mu_{ren}} - CKap_{ren,t-1}^{-\mu_{ren}}) \times \left(\frac{CKap_{ren,t-1}}{CKap_{ren,t}} \right)^{\beta_{ren}} \tag{14}$$

with $c_{ren}(t = \tau_1) = c_{ren}^0$,

The learning parameter μ_{ren} determines the learning rate *lr* and reflects a learning rate of 15 %, i.e. investment costs decrease by 15 % with every doubling of cumulative installed capacity. Parameter β_{ren} within the last factor of the right hand side of the equation causes a dampening similar to $\beta_{res,l}$ in the learning-by-doing equation of the fossil resource extraction (equation 9). Set to $\beta_{ren} = 0.4$, it prevents learning that is too fast.

There are three sources of carbon dioxide emissions: fossil fuel combustion, leakage from sequestered CO_2, and emissions from land-use and land-use change. The latter are described by an exogenous time series. Since fossil resources are measured in tons of carbon, resource use *R* and emissions *Em* coincide, except for land-use emissions and Carbon Capturing and Sequestration (CCS):

$$Em(t) = R(t) + LULUC(t) - R_{cap}(t) + LEAK(t) , \tag{15}$$

where R_{cap} denotes the amount of CO_2 captured in a given year; *LEAK* denotes leakage.

CCS is modeled as a chain process distinguishing six steps: CO_2 is captured at point sources (1) and transported via pipelines to sequestration sites (2). There, the CO_2 needs to be compressed (3) before it is injected into the sequestration site (4). Then, it either remains in the site (5) or leaks into the atmosphere (6). Processes 1-4 are capital intensive and are modeled as capital stocks representing available capacities for the individual processes. Capacities are built up by investments according to the following equation:

$$K_{pq}(t) = \int_{t_0}^{t} \omega_q (t - t') \iota_{pq}^{-1}(t') I_{pq}(t') dt' \tag{16}$$

Variables K_{pq} denote the capacities, index *p* denotes the process step, and the index *q* denotes different investment alternatives such as one of five distinct capture technologies or one of six distinct sequestration alternatives. Weighting parameters ω introduce a depreciation scheme for different vintages of the capital stocks, similar to equation 11 in case of renewable energy. Investments are denoted I_{pq} and the investment costs are ι_{pq}. Investment costs for capturing capacity range from ~100 $US/tC to ~450 $US/tC depending on the specific capture technology. When the productivity of CCS investments is varied in parameter studies later on in this paper, the same relative change is applied to the investment costs of each technology.

In addition to the limitation inflicted by the necessity to build up capacity, the amount of carbon that may be captured is limited by a static and a dynamic constraint. The static constraint limits the amount of carbon which can be captured from a large power plant as a fraction of the resource use in the business-as-usual scenario. The dynamic constraint defines an upper limit of investments into the specific capture technologies in each period. The upper limit is defined as a share of the investments in the power generation sector. The rationale is that the capability of retrofit investments in large power plants depends on the total amount of investments undertaken in the power generation sector.

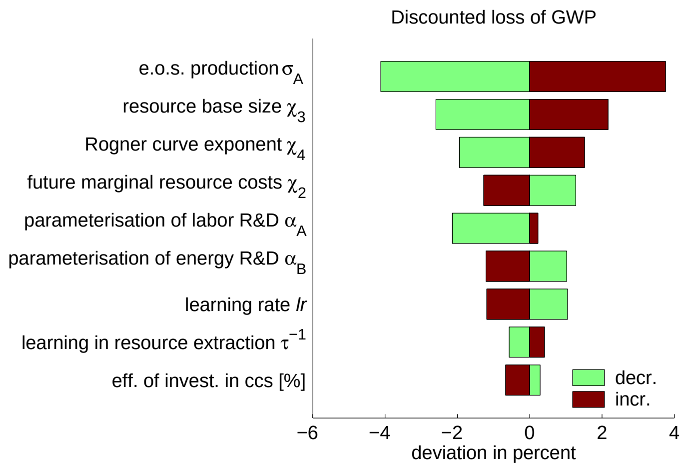
The injection of CO_2 into particular sequestration sites demands two different kinds of facilities: compressors and injection wells (steps 3 and 4). The modeling approach takes into account that both facilities demand investments and secondary energy. In steps 5 and 6, the modeling approach considers the capacity constraint of each sequestration alternative *j* and leakage of sequestered carbon: Leakage is described by a rate, and the capacity of each sequestration alternative is the upper bound for the cumulative amount of CO_2 that is injected into each sequestration alternative.

3. The Role of Endogenous Technological Change in MIND

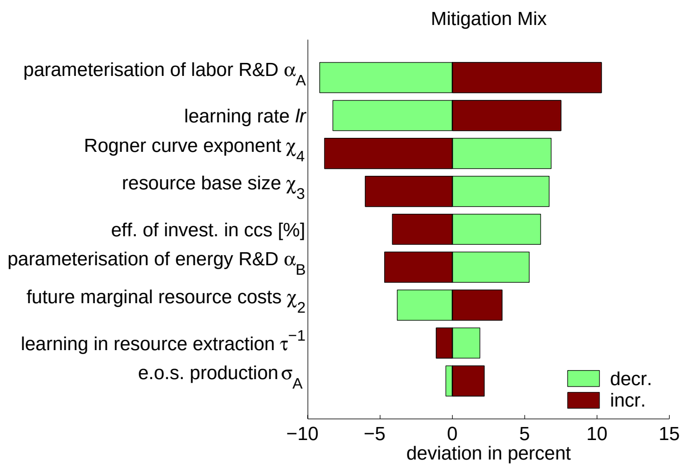
In which ways does endogenous technological change matter in policy scenarios computed with MIND? In the following sections, we provide an answer to this question with the help of a sensitivity analysis and miscellaneous parameter studies (for a first parameter study with MIND see Bauer et. al 2005). In the sensitivity analysis, we rank important technology-related model parameters according to their influence on two model outputs: the opportunity costs of climate protection and the mix of options used for CO_2 mitigation. We then study the effect of parameter variations on the same model outputs and analyze the underlying economic dynamics. All model runs constrain the atmospheric CO_2 concentration level to 450 ppm.

3.1 Local Sensitivity Analysis

Figure 1a and 1b show the influence of important parameters of MIND on opportunity costs of climate policy (1a) and on the mix of mitigation options (1b). The former are measured as losses of gross world product (GWP), accumulated from 2000 to 2100 and discounted to present value at a rate of 5 %, relative to the business-as-usual scenario. The latter is represented by the ratio of the two dominant options, renewable energies and CCS, where a ratio of unity implies that the same amount of CO_2 reductions may be attributed to each of the mitigation options. Parameter influence is measured by the response of the model to a 5 % variation of the parameter. Starting point is the set of parameters from model calibration. We vary one parameter at a time, hence the effects reflect local sensitivity. Local sensitivity analysis only assesses parameter sensitivity at one point in parameter space. It neglects the fact that sensitivities may be tremendously different at other points in parameter space. A measure of global sensitivity, i.e. a measure that takes into account simultaneous variation of several parameters, would remedy this shortcoming and is hence preferable. In this paper we stick with the analysis of local sensitivity for two reasons: First, the model response to a change in a single parameter under *ceteris paribus* condition is an intuitive measure. Second, the computational burden for a local analysis is much lower. We stress that while our analysis assesses model sensitivities as a property of the model and hence sheds light on the influence of parameters and the potential influence of their uncertainties on model results, we do not take into account parameter uncertainties. Therefore, we make no statements about the relative importance of parameters for the uncertainty of the computed results but about the potential influence on the results.



a



b

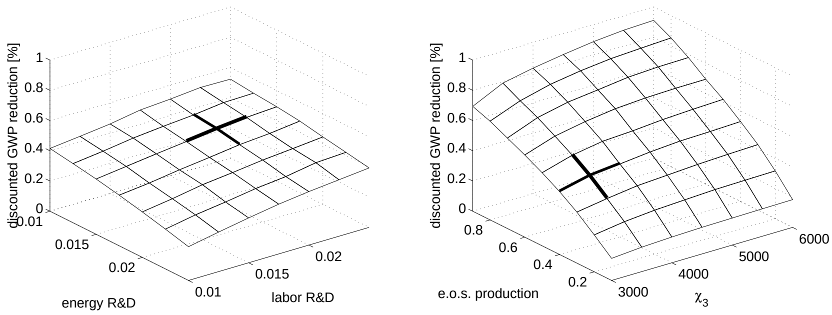
Figure 1: Sensitivity analysis. Figures 1a and 1b show the influence of important technological parameters on opportunity costs and mix of mitigation options, respectively. Metric is the deviation of the output in response to an up to 5 % increase (decrease) of the parameter. The parameter name "e.o.s. production" refers to the elasticity of substitution σ_A in aggregate industrial production, i.e. production of the gross world product.

As figure 1a indicates, the greatest influence on opportunity costs is exerted by the elasticity of substitution σ_A, followed by the parameters describing the availability of fossil resources, and the effectiveness of R&D investments in labor productivity. The latter and the top three parameters have a positive effect on costs, i.e. costs increase with the parameters, whereas assuming higher future costs of fossil resources decreases costs. The following ranks are occupied by the productivity of energy efficiency R&D and the learning rate of the renewable energy technologies, followed by two more sector specific parameters, the learning parameter in fossil resource extraction and the efficiency of investments in CCS. Overall, the relatively small responses of the model to parameter variations (less than 5 %) increase the confidence in the robustness of the computed opportunity costs. In the next two sections we will explore the reasons for this observation and explore the role of technological change in it.

Figure 1b shows in which way the same parameters influence the mix of mitigation options. A comparison between figure 1a and figure 1b indicates that the ranking has changed. Most notably, the elasticity of substitution has dropped to the last rank, but also two resource related parameters, χ_2 and χ_3, have dropped a few slots. Conversely, the parameterization of labor R&D, the learning rate of renewable technologies, and the efficiency of CCS investments have risen in the hierarchy. Overall, the mitigation mix is more sensitive (with variations up to 10 %) than the mitigation costs in figure 1a. This does not come as a surprise: GWP losses are closely related to social welfare, the maximization of which is the objective of MIND. Therefore, GWP loss is deliberately kept at a minimum. The mix of mitigation options, on the other hand, is determined to be cost-effective. Naturally, when parameter changes alter the competitiveness of mitigation options, the influence on the mitigation mix is significant.

3.2 Determinants of the Opportunity Costs

This section takes a closer look at the opportunity costs of climate protection. In the following we present parameter studies varying two parameters simultaneously. This enables us to discuss the effects of varying these parameters, as well as analyzing the interdependencies between them, hence taking a first step beyond a sensitivity analysis that is only local. Naturally, many parameters remain fixed at their default levels, so this analysis is still very much local in character. But by restricting us to the variation of two parameters at a time, we maintain the possibility of an intuitive graphical presentation of the results providing deeper insights into the workings of MIND.



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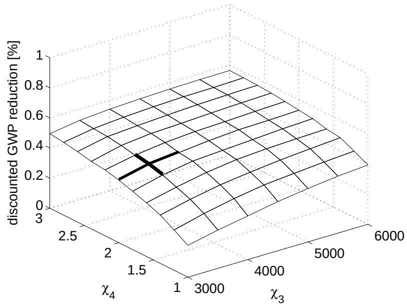

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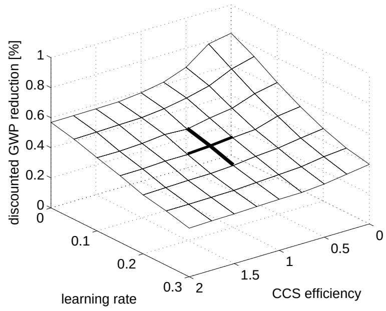

d

Figure 2: Figures in this panel show discounted gross world product loss (discount rate is 5 %) for several parameter studies. In figure 2a, energy R&D and labor R&D refer to the productivity of investment into research that enhances the efficiency of the corresponding factor. In 2b, e.o.s. production refers to the elasticity of substitution of production function in the aggregate industrial production sector. Parameters χ_3 and χ_4 in figure 2b and 2c refer to the size of the fossil resource base and the exponent of the Rogner curve, respectively. Figure 3d treats the learning rate of renewable technologies and the efficiency of investments in CCS technology. The pairs of default parameter values are indicated with a bold cross.

We start out by taking a look at the engine of endogenous growth in MIND: R&D investments that drive labor and energy efficiencies. Figure 2a displays the productivity of these investments. While the two parameters are similar with respect to the process they describe – accumulation of a knowledge stock increasing the productivity of an input factor to aggregate production – their effects on opportunity costs are contrary. An enhanced effectiveness of labor productivity R&D raises costs, while better energy efficiency R&D reduces GWP losses. This is due to opposite effects on the mitigation gap, i.e. the discrepancy of CO_2 emissions between business-as-usual and climate policy scenarios: More effective labor R&D stimulates additional economic growth and implies higher CO_2 emissions in the baseline. More effective energy R&D investments on the other hand facilitate much better energy efficiency in the baseline, and hence lower CO_2 emissions. The mitigation gap characterizes the challenge for the economy posed by climate protection goals and manifests itself in the opportunity costs.

Figure 2b compiles two parameters with an effect of the second type: the elasticity of substitution in the aggregate production sector, and the estimated size of the available fossil resources. Figure 2b shows that costs increase with the elasticity of substitution. This, too, we attribute to baseline effects: Higher elasticity of substitution implies a more flexible production technology which induces higher economic growth in business-as-usual. Therefore, achieving 450 ppm requires a substantial departure from the baseline and is relatively costly. A variation of the resource base has a bigger impact on the mitigation costs if the elasticity of substitution is relatively high. Low values of the elasticity of substitution lessen economic growth and consequently imply a lower demand for energy. At low energy demand, relaxing the scarcity of the resource has less of an effect. In general, a larger resource base allows higher economic growth in business-as-usual. When climate policy constrains resource use, it devaluates exhaustible resource as an economic asset and diminishes the rent income of their owners. The loss of rent income increases with the resource base because a relatively cheap and abundant resource can no longer be used as input in production.

We take yet a closer look at the fossil resource base. Figure 2c studies the variation of the size of the resource base χ_3 and parameter χ_4. Parameter χ_4 as well as the resource base are proxy variables for the technological progress in the extraction sector. Increasing χ_3, i.e. assuming more abundant resources, results in cheaper short to medium term supply of the fossil resource. Increasing χ_4 trades a slow and steady increase of the marginal costs for a steeper increase at a later time – thus making the resource cheaper and more easily available in the short to medium term. High values of χ_4 allow higher economic growth in the business-as-usual case and induce a relatively large mitigation gap. For high values of χ_4 the marginal costs of extraction are essentially constant. Under this condition an increased resource base has a moderate impact on macro-economic mitigation costs. For low values of χ_4, an increased resource base has a slightly higher impact on the macro-economic costs because marginal improvements in extraction already increase the shadow price of the resource. This parameter study shows that climate protection becomes relatively costly if there is a high rate of technological progress in the exploration and extraction of fossil fuels. Accelerated technological progress in the extraction sector makes climate policy more costly, because such policy devaluates assets (resources and capital stock in the corresponding sectors). Therefore, special attention ought to be paid to assumptions about resource availability and their uncertainties.

Contrary effects can be observed if technological progress decreases the costs of mitigation technologies. The impact on opportunity costs is shown in figure 2d. We explore two parameters which are both closely related to mitigation options: the efficiency of investments into Carbon Capture and Sequestration technologies (CCS) and the learning rate of renewable energy technologies. Varying these two parameters shifts the competitive advantage between the two mitigation options and, consequently, the extent to which they are used. It turns out that the efficiency of CCS investments has no strong impact on the overall opportunity costs if the learning rate of renewable energy technologies is relatively high. The reason is that renewables are modeled as a backstop technology, i.e. as a carbon-free energy source, and need no non-reproducible input for energy production. In contrast to the renewables, CCS investments only bridge from the fossil fuel age to a carbon-free era. CCS makes the transition of the energy system smoother but has severe limitations if fossil fuels become more costly because of increasing marginal extraction costs at the end of the 21st century. At the same time, renewable energy becomes cheaper because of learning-by-doing. It is plausible that this effect cannot be altered by high efficiencies of CCS investments. At low learning rates of the backstop technology CCS becomes more important.

3.3 Mitigation strategies

In this section we analyze the impact of the same parameters explored in the previous section on the option portfolio of an optimal mitigation strategy. Mitigation options are compared on the basis of the amount of CO_2 that they enable the economy to reduce. For the CCS option, this is straightforward: it is simply the amount of captured and sequestered CO_2 (less the amount that leaks from the sequestration site). In case of energy related mitigation options, i.e. renewable energy and energy efficiency improvements, the corresponding amount of "mitigated CO_2 emissions" was derived from the equivalent amount of energy from fossil fuels. In MIND, the degree of efficiency on converting primary- into final energy is determined endogenously in the production function of the fossil sector. In this ex post analysis, however, we estimate the "equivalent" amount of fossil energy by assuming a fix coefficient. The remaining mitigation options, namely energy savings by substitution of energy at the levels of energy transformation and aggregate production, are visualized as the difference to the total reduction of CO_2.

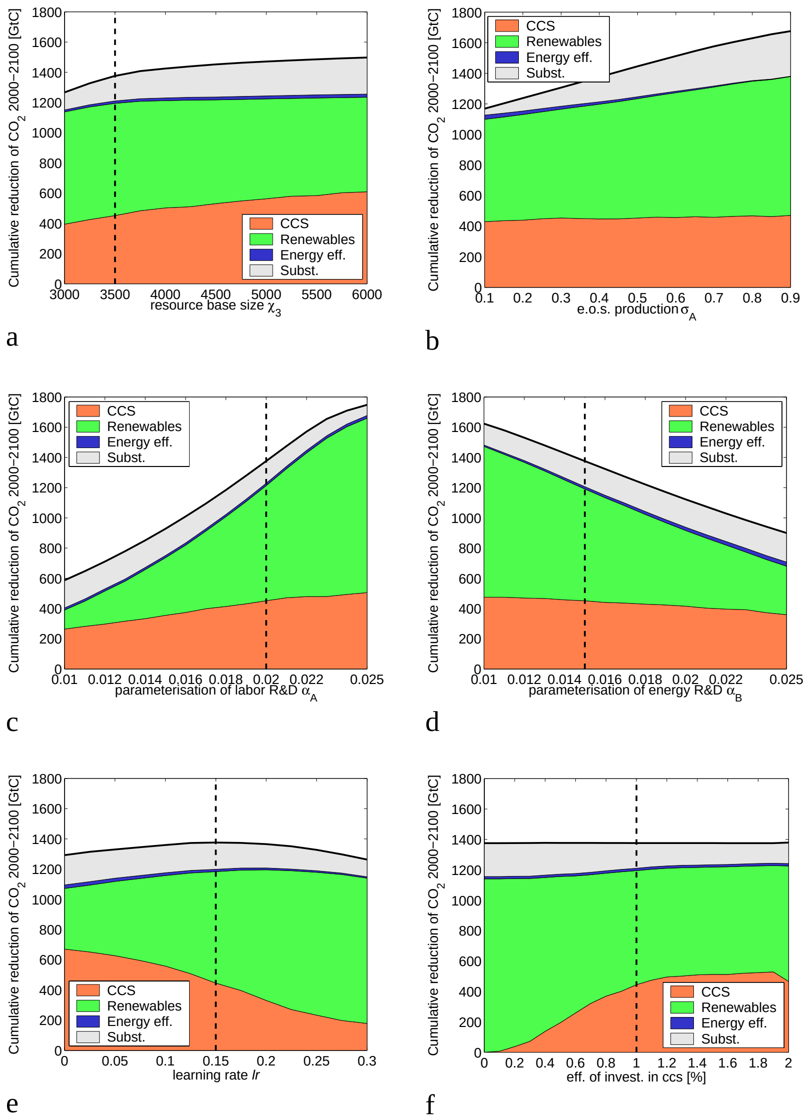

Figure 3: Figures 3a-f show how the mix of mitigation options varies in parameter studies. CO_2 reductions caused by avoiding the use of fossil fuels (renewable energy, energy efficiency improvements, and substitution) are estimated from the alternative use of fossil fuels. Dashed lines indicate the default parameter value.

Figure 3a shows that the amount of CCS within the portfolio of mitigation options increases with the assumed resource base. The cumulative amount of CO_2 reduced by renewables within the next century decreases, energy efficiency remains constant and energy savings increase. An increasing resource base implies increasing rents for the owners. This increasing rent income makes CCS a more profitable option. Due to high economic growth and relatively cheap fossil fuels, the return on investment in renewables falls short of the returns on CCS investments.

In figure 3b, energy savings (reduction of energy consumption by substituting energy by capital in different sectors) become more profitable if the elasticity of substitution increases; at the same time, the importance of energy efficiency decreases.

A more surprising result is obtained in figure 3c and 3d. In figure 3c an increasing productivity of R&D investment in labor enhancing activities also increases the share of renewables in the mitigation portfolio. The explanation is as follows: Economic growth induces additional energy demand that is met by carbon-free technologies. Due to high economic growth, marginal extraction costs of fossil fuels increase sooner, and thus CCS is less competitive compared to renewables. In contrast, when R&D investments in energy efficiency become more productive, the mitigation gap shrinks, and the share of renewables within the mitigation portfolio decreases (3d). Interestingly, changes in the productivity of energy R&D investments affect the baseline rather than providing a more attractive mitigation option: In this study, the energy efficiency parameter varies from 63 to 245 % of its regular value in 2100 in the baseline, the latter implying that energy use in 2100 is decreased by 60%. In contrast, climate policy only induces 0.4 to 2.7 % additional increases of the efficiency parameter. In conclusion, higher energy efficiency and a lower baseline for economic growth reduce the demand for renewables. The importance of the renewable energy option depends heavily on the underlying economic growth path.

As figure 3e shows, high learning rates in the renewable energy sector reduce the optimal amount of CCS substantially. In that sense CCS can be seen as a joker-option if the learning rate of the renewables is relatively low. It is also remarkable that energy savings are less important when the learning rate is relatively high because the energy demand can be met by the carbon-free renewables. Learning-by-doing reduces the price of electricity produced by renewables and increases the demand for renewables which reduces their costs further. This feedback loop makes CCS less important. As figure 3f indicates, this effect can be counteracted by an increasing efficiency of CCS-investments.

4. Concluding Remarks

In which ways does technological change matter? Our analysis shows that technological change works in two “directions”: We identify technological progress that permeates the entire economy and technological progress that is restricted in its effects to a single sector. Examples for such sector-specific technological change are learning-by-doing effects associated with renewable energy technologies and resource extraction, as well as technological progress in CCS, here modeled via its investment efficiency. In MIND, parameters associated with such sector specific technological change have a significant impact[2] on the optimal mix of mitigation options. For example, an increased learning rate increases the share of renewables, and improved investment efficiency in CCS increases the share of CCS within the entire portfolio of mitigation options

[2] We refer to the impact of a parameter in terms of a relatively large potential influence, i.e. a large sensitivity of results to changes of this parameter. Recall, however, that the actual uncertainty about parameters is not taken into account.

(figures 1b and 3ef). However, these parameters are less important in determining the overall opportunity costs of climate protection which measure the impact on the overall economy (figure 1a).

In contrast, there is technological change with significant impact on the macro-economic growth process, evident in its influence on opportunity costs. Such technological change is described by parameters of the macro-economic environment, like the elasticity of substitution, and the parameters characterizing the effectiveness of labor- and energy R&D investments. Labor R&D investments in particular have a strong influence on macro-economic growth as well as the mix of mitigation options. Progress in resource extraction is an example of sector-specific technological change with a macro-economic impact. This progress is characterized by the parameters of Rogner's scarcity curve and has been shown to exert a significant influence on opportunity costs. The most prominent effect of these parameters is their impact on the baseline.

We conclude that feedbacks between the macro-economy and the energy system are crucial for determining mitigation costs and the development of the mitigation portfolio in time. The case of technological change in resource extraction shows how sector-specific processes may exert significant influence on the macro-economy, while the impact of labor R&D productivity on the share of renewable energy is an example of macro-economic influence on a distinct sector.

This has implication for policies. A sector-specific policy that fostered technological change in the extraction sector induced by increasing prices in the oil or gas market would increase the opportunity costs of climate protection. A policy that increased the economy-wide energy efficiency in all energy related sectors would reduce the costs of climate protection substantially. Enhancing technological change in the extraction sector made sense if decision makers only intended to increase energy security. However, they ought to take into account the impact of such a policy on the opportunity costs of climate protection.

The results presented here indicate that partial-equilibrium models omitting intertemporal and inter-sectoral aspects can be misleading for designing a climate- and energy policy. Thus, they stress the utility of hybrid models incorporating endogenous technological change at the sector level as well as at the macro-economic level. Moreover, hybrid models pose a coherent framework not only for the assessment of the opportunity costs and portfolios of mitigation strategies but also for the design of climate- and energy policy instruments.

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CCMP	60.2005	*Andreas LÖSCHEL and Dirk T.G. RÜBBELKE*: Impure Public Goods and Technological Interdependencies
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KTHC	67.2005	*Sandra WALLMAN* (lxxiv): Network Capital and Social Trust: Pre-Conditions for 'Good' Diversity?
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KTHC	69.2005	*Eric M. USLANER* (lxxiv): Varieties of Trust
KTHC	70.2005	*Thomas P. LYON* (lxxiv): Making Capitalism Work: Social Capital and Economic Growth in Italy, 1970-1995
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KTHC	73.2005	*Renato SANSA and Ercole SORI* (lxxv): Governance of Diversity Between Social Dynamics and Conflicts in Multicultural Cities. A Selected Survey on Historical Bibliography
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IEM	75.2005	*Margherita GRASSO and Matteo MANERA*: Asymmetric Error Correction Models for the Oil-Gasoline Price Relationship
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ETA	78.2005	*Joëlle NOAILLY, Jeroen C.J.M. van den BERGH and Cees A. WITHAGEN* (lxxvi): Local and Global Interactions in an Evolutionary Resource Game
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CCMP	80.2005	*Massimiliano MAZZANTI and Roberto ZOBOLI*: Economic Instruments and Induced Innovation: The Case of End-of-Life Vehicles European Policies
NRM	81.2005	*Anna LASUT*: Creative Thinking and Modelling for the Decision Support in Water Management
CCMP	82.2005	*Valentina BOSETTI and Barbara BUCHNER*: Using Data Envelopment Analysis to Assess the Relative Efficiency of Different Climate Policy Portfolios
ETA	83.2005	*Ignazio MUSU*: Intellectual Property Rights and Biotechnology: How to Improve the Present Patent System
KTHC	84.2005	*Giulio CAINELLI, Susanna MANCINELLI and Massimiliano MAZZANTI*: Social Capital, R&D and Industrial Districts
ETA	85.2005	*Rosella LEVAGGI, Michele MORETTO and Vincenzo REBBA*: Quality and Investment Decisions in Hospital Care when Physicians are Devoted Workers
CCMP	86.2005	*Valentina BOSETTI and Laurent GILOTTE*: Carbon Capture and Sequestration: How Much Does this Uncertain Option Affect Near-Term Policy Choices?
CSRM	87.2005	*Nicoletta FERRO*: Value Through Diversity: Microfinance and Islamic Finance and Global Banking
ETA	88.2005	*A. MARKANDYA and S. PEDROSO*: How Substitutable is Natural Capital?
IEM	89.2005	*Anil MARKANDYA, Valeria COSTANTINI, Francesco GRACCEVA and Giorgio VICINI*: Security of Energy Supply: Comparing Scenarios From a European Perspective
CCMP	90.2005	*Vincent M. OTTO, Andreas LÖSCHEL and Rob DELLINK*: Energy Biased Technical Change: A CGE Analysis
PRCG	91.2005	*Carlo CAPUANO*: *Abuse of Competitive Fringe*
PRCG	92.2005	*Ulrich BINDSEIL, Kjell G. NYBORG and Ilya A. STREBULAEV* (lxv): Bidding and Performance in Repo Auctions: Evidence from ECB Open Market Operations
CCMP	93.2005	*Sabrina AUCI and Leonardo BECCHETTI*: The Stability of the Adjusted and Unadjusted Environmental Kuznets Curve
CCMP	94.2005	*Francesco BOSELLO and Jian ZHANG*: Assessing Climate Change Impacts: Agriculture
CTN	95.2005	*Alejandro CAPARRÓS, Jean-Christophe PEREAU and Tarik TAZDAÏT*: Bargaining with Non-Monolithic Players
ETA	96.2005	*William BROCK and Anastasios XEPAPADEAS* (lxxvi): Optimal Control and Spatial Heterogeneity: Pattern Formation in Economic-Ecological Models
CCMP	97.2005	*Francesco BOSELLO, Roberto ROSON and Richard S.J. TOL* (lxxvii): Economy-Wide Estimates of the Implications of Climate Change: Human Health
CCMP	98.2005	*Rob DELLINK, Michael FINUS and Niels OLIEMAN*: Coalition Formation under Uncertainty: The Stability Likelihood of an International Climate Agreement
CTN	99.2005	*Valeria COSTANTINI, Riccardo CRESCENZI, Fabrizio De FILIPPIS, and Luca SALVATICI*: Bargaining Coalitions in the Agricultural Negotiations of the Doha Round: Similarity of Interests or Strategic Choices? An Empirical Assessment
IEM	100.2005	*Giliola FREY and Matteo MANERA*: Econometric Models of Asymmetric Price Transmission
IEM	101.2005	*Alessandro COLOGNI and Matteo MANERA*: Oil Prices, Inflation and Interest Rates in a Structural Cointegrated VAR Model for the G-7 Countries
KTHC	102.2005	*Chiara M. TRAVISI and Roberto CAMAGNI*: Sustainability of Urban Sprawl: Environmental-Economic Indicators for the Analysis of Mobility Impact in Italy
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NRM	109.2005	*Antonio MUSOLESI and Mario NOSVELLI*: Water Consumption and Long-Run Urban Development: The Case of Milan
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NRM	114.2005	*Gilles LAFFORGUE and Walid OUESLATI:* Optimal Soil Management and Environmental Policy

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KTHC	121.2005	*Valeria GATTAI and Corrado MOLTENI:* Dissipation of Knowledge and the Boundaries of the Multinational Enterprise
KTHC	122.2005	*Valeria GATTAI:* Firm's Intangible Assets and Multinational Activity: Joint-Venture Versus FDI
CCMP	123.2005	*Socrates KYPREOS*: A MERGE Model with Endogenous Technological Change and the Cost of Carbon Stabilization
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NRM	136.2005	*Chi-CHUR CHAO, Bharat R. HAZARI, Jean-Pierre LAFFARGUE, Pasquale M. SGRO, and Eden S. H. YU* (lxxviii): Tourism, Jobs, Capital Accumulation and the Economy: A Dynamic Analysis
NRM	137.2005	*Michael MCALEER, Riaz SHAREEF and Bernardo da VEIGA* (lxxviii): Risk Management of Daily Tourist Tax Revenues for the Maldives
NRM	138.2005	*Guido CANDELA, Paolo FIGINI and Antonello E. SCORCI* (lxxviii): The Economics of Local Tourist Systems
NRM	139.2005	*Paola De AGOSTINI, Stefania LOVO, Francesco PECCI, Federico PERALI and Michele BAGGIO* (lxxviii): Simulating the Impact on the Local Economy of Alternative Management Scenarios for Natural Areas
NRM	140.2005	*Simone VALENTE* (lxxviii): Growth, Conventional Production and Tourism Specialisation: Technological Catching-up Versus Terms-of-Trade Effects
NRM	141.2005	*Tiago NEVES SEQUEIRA and Carla CAMPOS* (lxxviii): International Tourism and Economic Growth: a Panel Data Approach
NRM	142.2005	*Francesco MOLA and Raffaele MIELE* (lxxviii): An Open Source Based Data Warehouse Architecture to Support Decision Making in the Tourism Sector
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NRM	144.2005	*S. MARZETTI Dall'ASTE BRANDOLINI and R. MOSETTI* (lxxviii): Social Carrying Capacity of Mass Tourist Sites: Theoretical and Practical Issues about its Measurement
NRM	145.2005	*Sauveur GIANNONI and Marie-Antoinette MAUPERTUIS* (lxxviii): Environmental Quality and Long Run Tourism Development a Cyclical Perspective for Small Island Tourist Economies
NRM	146.2005	*Javier LOZANO, Carlos GÓMEZ and Javier REY-MAQUIEIRA* (lxxviii): An Analysis of the Evolution of Tourism Destinations from the Point of View of the Economic Growth Theory
CCMP	147.2005	*Valentina BOSETTI and Laurent DROUET*: Accounting for Uncertainty Affecting Technical Change in an Economic-Climate Model
NRM	148.2005	*Mondher SAHLI and Jean-Jacques NOWAK* (lxxviii): Migration, Unemployment and Net Benefits of Inbound Tourism in a Developing Country
ETA	149.2005	*Michael GREENSTONE and Justin GALLAGHER*: Does Hazardous Waste Matter? Evidence from the Housing Market and the Superfund Program
CCMP	150.2005	*Ottmar EDENHOFER, Kai LESSMANN and Nico BAUER*: Mitigation Strategies and Costs of Climate Protection: The effects of ETC in the hybrid Model MIND

(lxv) This paper was presented at the EuroConference on “Auctions and Market Design: Theory, Evidence and Applications” organised by Fondazione Eni Enrico Mattei and sponsored by the EU, Milan, September 25-27, 2003

(lxvi) This paper has been presented at the 4th BioEcon Workshop on “Economic Analysis of Policies for Biodiversity Conservation” organised on behalf of the BIOECON Network by Fondazione Eni Enrico Mattei, Venice International University (VIU) and University College London (UCL) , Venice, August 28-29, 2003

(lxvii) This paper has been presented at the international conference on “Tourism and Sustainable Economic Development – Macro and Micro Economic Issues” jointly organised by CRENoS (Università di Cagliari e Sassari, Italy) and Fondazione Eni Enrico Mattei, and supported by the World Bank, Sardinia, September 19-20, 2003

(lxviii) This paper was presented at the ENGIME Workshop on “Governance and Policies in Multicultural Cities”, Rome, June 5-6, 2003

(lxix) This paper was presented at the Fourth EEP Plenary Workshop and EEP Conference “The Future of Climate Policy”, Cagliari, Italy, 27-28 March 2003

(lxx) This paper was presented at the 9th Coalition Theory Workshop on "Collective Decisions and Institutional Design" organised by the Universitat Autònoma de Barcelona and held in Barcelona, Spain, January 30-31, 2004

(lxxi) This paper was presented at the EuroConference on “Auctions and Market Design: Theory, Evidence and Applications”, organised by Fondazione Eni Enrico Mattei and Consip and sponsored by the EU, Rome, September 23-25, 2004

(lxxii) This paper was presented at the 10th Coalition Theory Network Workshop held in Paris, France on 28-29 January 2005 and organised by EUREQua.

(lxxiii) This paper was presented at the 2nd Workshop on "Inclusive Wealth and Accounting Prices" held in Trieste, Italy on 13-15 April 2005 and organised by the Ecological and Environmental Economics - EEE Programme, a joint three-year programme of ICTP - The Abdus Salam International Centre for Theoretical Physics, FEEM - Fondazione Eni Enrico Mattei, and The Beijer International Institute of Ecological Economics

(lxxiv) This paper was presented at the ENGIME Workshop on “Trust and social capital in multicultural cities” Athens, January 19-20, 2004

(lxxv) This paper was presented at the ENGIME Workshop on “Diversity as a source of growth” Rome November 18-19, 2004

(lxxvi) This paper was presented at the 3rd Workshop on Spatial-Dynamic Models of Economics and Ecosystems held in Trieste on 11-13 April 2005 and organised by the Ecological and Environmental Economics - EEE Programme, a joint three-year programme of ICTP - The Abdus Salam International Centre for Theoretical Physics, FEEM - Fondazione Eni Enrico Mattei, and The Beijer International Institute of Ecological Economics

(lxxvii) This paper was presented at the Workshop on Infectious Diseases: Ecological and Economic Approaches held in Trieste on 13-15 April 2005 and organised by the Ecological and Environmental Economics - EEE Programme, a joint three-year programme of ICTP - The Abdus Salam International Centre for Theoretical Physics, FEEM - Fondazione Eni Enrico Mattei, and The Beijer International Institute of Ecological Economics.

(lxxviii) This paper was presented at the Second International Conference on "Tourism and Sustainable Economic Development - Macro and Micro Economic Issues" jointly organised by CRENoS (Università di Cagliari and Sassari, Italy) and Fondazione Eni Enrico Mattei, Italy, and supported by the World Bank, Chia, Italy, 16-17 September 2005.

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