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EFET DISCUSSION PAPER ON CARBON ABATEMENT MEASURES

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The prolonged oversupply of, and the ensuing weak secondary market in, EU ETS allowances (EUAs) over recent years has led some EU countries to introduce or consider additional carbon abatement measures. The intention of policymakers, when introducing mechanisms such as a carbon floor price or carbon tax, may be to strengthen the carbon abatement signal to promote low carbon investments, or to accelerate closure of carbon-intense coal-fired generation in the relevant countries.

EFET advocates investment in low carbon technology driven by Europe-wide market signals, accompanied by a reduction in direct national subsidies for renewable energy projects. We believe that **strengthening the EU ETS is the most effective solution to allow cost-efficient carbon abatement, avoiding energy market distortions and fragmentation of the European carbon market.**

The European Emissions Trading System (EU ETS) was designed to be a cornerstone of the EU energy and climate policy. It would provide a robust EU-wide price signal for investing in low-carbon technologies and ensure cost-efficient decarbonisation of the EU economy. Indeed, unlike 'command and control' regulation, the EU ETS has the capacity to harness market forces to deliver cost-efficient emissions reduction. The EU ETS is the world's largest emissions trading market, accounting for over three-quarters of international carbon trading. However, in recent years, the functioning of the EU ETS has been hampered by an oversupply of carbon allowances. This stems from a combination of factors, including overlapping policies at EU and national levels, as well as the economic downturn of the past decade.

To reduce this oversupply in allowances, in February 2018 the EU officially approved the reform of the EU ETS for the trading period 2021-2030 (Phase 4). These measures include a gradual reduction of surplus allowances from the market through the Market Stability Reserve (MSR), an increase of the Linear Reduction Factor (LRF) and eventually a substantial cancellation of allowances from the MSR.

Despite these reforms, questions remain, among many Member States and industry, whether their implementation will suffice in delivering a strong carbon abatement signal. This risk is partly due to the negative effect on EUAs supply of current out-of-market decarbonisation policies that overlap with the EU ETS effective functioning. Therefore, the debate about the need for further measures and reforms continues.

Experience in implementing national carbon price floors has shown that particular attention should be given to political risk. EFET fears that the introduction of national or regional carbon price mechanisms will serve to undermine the EU ETS as a mechanism for abatement.

Uncoordinated introduction of national or regional mechanisms may bring a number of adverse consequences for both carbon and power markets, such as

- A waterbed effect whereby a decrease in emissions in one country (or sector) is offset by an increase in neighbouring countries (or sectors), due to the relocation of generation or manufacturing assets, thus harming the effectiveness of the EU ETS as the primary mechanism for abatement;
- Carbon leakage through distortions to the interconnected EU power markets, since different CO2-prices would result in different power prices across borders, thereby re-locating the emissions to power plants outside of the carbon floor price area;
- Greater fragmentation of the EU carbon allowances market and the related climate change policies, resulting in distortions within the EU single energy market;
- Barriers to linking the EU ETS scheme with compatible schemes on a global level. Setting the level of a carbon tax is difficult because it needs to calibrate to an emissions target to ensure cost efficient carbon reduction.

Experience in implementing national mechanisms aimed at strengthening carbon abatement signal has shown that particular attention should be given to political risk assessment, as such mechanisms are sensitive to lobbying and political bargaining, which is difficult to forecast and hedge against.

Should Member States nevertheless decide to resort to carbon floor prices or other national incentives and carbon abatement measures**, it is essential that they ensure a high degree of coordination with the EU ETS. Otherwise they risk creating distortions in the European carbon market**. Furthermore, any national measures that overlap with the EU ETS should be temporary, with clear objectives for their removal to enable market participants to forecast and manage such an eventuality.

We advise policymakers to let the EU ETS reform deliver its first results – especially in the light of a recent market tightening proving that the EU is on track with their reforms – before considering modifying it or supplementing it with other carbon abatement measures. Any further interventions in the EU ETS have to be made only after the implementation of the latest reform takes place. Policy decisions on carbon abatement measures should therefore be informed by a proper assessment of the reformed EU ETS performance. To conclude, EFET believes that **continued support for the EU ETS is necessary to ensure an EU-wide, market-based measure remains the cornerstone of decarbonisation policy.**