National carbon floor prices and carbon taxation in EU ETS sectors

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IETA Members are concerned that EU Member States are either introducing, or considering introducing, additional carbon pricing measures in sectors covered by the EU Emissions Trading System (EU ETS). Now that the landmark reforms for Phase 4 of the EU's carbon market have been concluded, introduction of additional national carbon pricing mechanisms – such as taxes or carbon price floors – risks jeopardising the effort already invested in robustly reforming the market.

The emergence of national and regional carbon pricing initiatives would fragment the EU's carbon market, reducing its efficiency and leading to competitive distortions without substantial CO_2 reductions across the EU. A national carbon tax overlapping with the EU ETS would lead to emission reductions at higher cost in those countries, but it would also lead to an increase in emissions elsewhere (the so-called 'waterbed effect'). In addition, as carbon taxes are likely to be differentiated not only between countries but also between sectors and possibly fuels, they would reduce the system's efficiency by eliminating a uniform CO_2 price signal – as opposed to an EU-wide mechanism.

Beyond these points, there are also several challenges and downsides to introducing national carbon pricing mechanisms that overlap with the EU ETS:

- National carbon pricing mechanisms for the power sector risk undermining industrial decarbonisation efforts, even within the same country. The threat of depressed EUA prices because of national regulations will negatively impact industrial low carbon investment strategies. This will also undermine one of the aims of the Phase 4 reforms which sought a balance between an increased linear reduction factor of 2.2% and robust free allocation to industry to offset the risk of carbon leakage;
- National carbon pricing mechanisms increase indirect costs to industry by increasing electricity prices. In turn, this increases the risk of carbon leakage from the country imposing the national mechanism;
- Setting the level of a carbon tax is difficult because it needs to calibrate to an emissions target and ensure cost efficient carbon reduction. In contrast, a cap and trade system guarantees the delivery of the environmental target set by the cap, and establishes a price that reflects the marginal cost of abatement;
- Tax levels are sensitive to lobbying and are often driven by the needs of individual states' budgets. It is also impossible to hedge against political alterations in the carbon tax (as opposed to ETS price movements);
- Carbon taxes that overlap with the EU ETS constitute a potential barrier to linking with emissions trading systems in other jurisdictions; and
- Instead of introducing additional taxes, Member States should assess the potential to extend coverage of the EU ETS to additional sectors and gases.

Recommendations

IETA recommends Member States to refrain from introducing national carbon floor prices or taxes that overlap with the EU's carbon market and fully adhere to their joint political decision on the EU ETS to remain a primary tool for emission reductions in the EU. The EU ETS has established a liquid and efficient market for emission allowances with a broad and diverse range of market participants, efficiently achieving the set climate targets.

We call on Member States to remain committed to enhance the effectiveness of the EU ETS, as a robustly functioning market would not need to be complemented by additional national measures. A functioning and efficient market requires minimum intervention and avoidance of market fragmentation. Implementing national carbon price-setting rules would fragment the market, deliver no additional environmental effects and distort competition within the EU single market.

IETA takes note of those Member States who are considering national measures that overlap with the EU ETS. Our strong recommendation remains that Member States should maintain commitment to the EU ETS as the primary tool for European emission reductions and not introduce additional carbon pricing measures. If Member States do decide to introduce such measures, it would be critical that they ensure a high degree of coordination. This would minimise market distortions and avoid excessive market fragmentation. National measures that overlap with the EU ETS should be temporary, as the system absorbs accumulated surplus through the Market Stability Reserve. IETA also notes the transparency requirements in the revision of the EU ETS Directive[1]. Article 3 Transposition, Paragraph 2 requires Member States to "communicate to the Commission the text of the main measures of national law which they adopt in the field covered by this Directive." This transparency should discourage the use of national measures that overlap with the EU ETS and ensure that the Commission has sufficient information to understand their detrimental effect.

Furthermore, if additional carbon pricing measures are introduced in EU ETS sectors, to minimize negative impacts on the EU carbon market Member States should:

- **Transparently quantify their impact** in terms of emission reductions within the scope of the EU ETS.
- **Voluntarily cancel an adequate amount of allowances** from their auction volumes in order to mitigate the impact of the measure on the functioning of the EU ETS.

This statement is complementary to IETA's Position Paper on Overlapping Policies with the EU (2015).[2]

1 DIRECTIVE (EU) 2018/410 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814 (Text with EEA relevance)

2 Overlapping Policies with the EU ETS, IETA Position Paper, July 2015 http://www.ieta.org/resources/EU/Overlapping_Policies_Drafting_Group/ieta_overlapping_policies_paper_10072015_final.pdf