European Federation of Energy Traders
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Carbon pricing design for the Energy Community: focusing on pathways to joining the EU ETS

The European Federation of Energy Traders (EFET)[1] welcomes the opportunity provided by the Energy Community Secretariat to submit feedback on the presentation of the upcoming study on carbon pricing design for the Energy Community (EnC) held on 26 March 2020.

We believe that this study is very timely as it aims to evaluate the design of carbon pricing schemes and mechanisms, which could drive decarbonisation across the EnC Contracting Parties (CPs) in the most cost-efficient way.

We fully support the key premise of the study presented by the consultant, which is that a cap and trade system constitutes the preferred policy solution for CPs compared to alternative carbon abatement measures, such as a carbon tax.

At the same time, we believe that when it comes to assessing these policy options, apart from “simplicity” and “flexibility”, a key criterion which should be recognised as a driver for policymakers’ decisions is **cost-efficiency** of a given policy option.

The EU ETS constitutes the cornerstone of the EU energy and climate policy and it plays an important role as a credible harmonised EU-wide carbon pricing scheme. Indeed, unlike ‘command and control’ regulation, **the EU ETS has the capacity to harness market forces to deliver cost-efficient emissions reduction**.

We recognise that the coronavirus crisis has resulted into a substantial increase in surplus of EUAs. At the same time, the MSR, along with its forthcoming review, and the revision of the EU ETS Directive foreseen by the European Green Deal have the capacity to facilitate continued strengthening and extension of **the EU ETS as the long-term driver for decarbonisation across the economy.**

As the CPs are seeking to join the single EU energy market, it is crucial to ensure they are also preparing for entering the European carbon market, by way of joining the European Emissions Trading System (EU ETS).

Having in mind all the above, we believe that development of roadmaps or pathways for the CPs to join the EU ETS would be a valuable output of the study.

Joining the EU ETS would facilitate cost-efficient carbon abatement across the EnC CPs, while preventing potential energy market distortions and fragmentation of the European carbon market in the future and ultimately enabling the EnC CPs to properly integrate in the European internal energy market (IEM).

[1] The European Federation of Energy Traders (EFET) promotes competition, transparency and open access in the European energy sector. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. We currently represent more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

While we believe that ensuring a healthy level playing field between the EU and EnC CPs is crucial (in particular, to avoid carbon leakage towards the CPs), we recognise that the pathway towards integration of the CPs into the EU IEM should take into account the social and economic challenges in the respective countries.

Considering the findings of the EnC study on direct and indirect to coal electricity production in the EnC CPs (hereafter the EnC study), we would like to propose a two-phase approach, which would pave the way for the EnC CPs to join the EU ETS.

- Phase 1: Phasing out local subsidies, while protecting vulnerable consumers.

The EnC study demonstrates that "the existing electricity generation from coal receives significant subsidies, which **disrupt the proper functioning of the electricity marke**t, favour production of a resource with a highly negative impact on the environment and obscure real financial and economic performance of the electric power system in the coal sector."[2]

Phasing out local subsidies is therefore a key prerequisite to move towards creating a level playing field for market participants in the EU and the EnC CPs and allowing proper integration of the CPs into the EU IEM.

At the same time, the necessary actions are required to ensure that vulnerable consumers across the CPs are not left behind. This includes implementing structural measures, such as direct payments, dedicated tax breaks, enhanced social policy and energy efficiency measures.

- Phase 2: Establishing a roadmap for implementation of the relevant legislative and market infrastructure across the EnC CPs to enable an EU ETS extension which would cover the CPs.

The EnC ETS would need to be designed to be fully compatible for linking with the EU ETS from the very beginning (like in the case of Norway). Apart from that, the proposed roadmap should factor in a progressive extension of the EU ETS to cover the CPs taking into account the EUA market dynamics in the EU in the aftermath of the coronavirus crisis.

We believe that the study should also consider the adverse consequences which uncoordinated introduction of national or regional mechanisms may bring 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 European 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;

[2] Rocking the Boat: What is keeping the Energy Community's Coal Sector Afloat? Analysis of Direct and Selected Hidden Subsidies to Coal Electricity Production in the Energy Community Contracting Parties, Energy Community Secretariat, September 2019, p.22

- Barriers to linking the EU ETS scheme with compatible schemes across the CPs. 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 the EnC CPs 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. 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.