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EU carbon market report underlines the need to end pollution handouts

While the EU carbon market is helping to clean up Europe's power sector, industrial CO2 pollution remained stubbornly high, and that from aviation kept growing in 2019. This is partly due to overly generous handouts of pollution permits. These subsidies must be phased out to incentivise cleaner production and more sustainable transport as the scheme is reviewed starting next year.

The European Commission has published its annual report on the functioning of the EU carbon market (EU emissions trading system, EU ETS) which is up for a review as part of the EU Green Deal. Below is an overview of some of the key issues as well as Carbon Market Watch's proposals for improving it.

Polluters don't pay

According to the report, between 2013 and 2020, more than 6 billion pollution permits were handed out for free to installations deemed to be at risk of 'carbon leakage' (industry moving production to parts of the world with laxer or no environmental regulations). This is almost a half, 43%, of the total quantity of available allowances. Given the fact that the power sector pays for its pollution, the large majority of free allocation has gone to manufacturing industries such as steel, cement, and chemicals. In fact, more than 90% of industrial carbon pollution does not carry any cost for polluting companies.

Due to the free allocation and other exemptions, the system does not provide an incentive for industry to invest in cleaner production processes and solutions which are needed to drive its climate-friendly transition. This becomes clear when looking at the data: In 2019, greenhouse gas pollution from ETS installations dropped by 9% compared to 2018, but this was mostly driven by the power sector, thanks to a strong pick-up of renewable energy and reduced use of coal. Looking at the industrial sector alone, for the 9th year in a row it registered a meagre 1.9% reduction in carbon emissions.

The free allocation does not only slow down emission reductions, it also means foregone revenues from auctioning for EU governments at a time when public finances are stretched.

During the last EU carbon market revision, decision-makers agreed to hand out 6.3 billion allowances, valued at about €165 billion, during the next trading period (2021-2030) alone.

The next review that comes much sooner than anticipated will be a golden opportunity to rectify this costly mistake. All forms of free allocation should be phased out, especially if the EU introduces a carbon border adjustment measure to price pollution of imports into the EU.

The European Court of Auditors also recently outlined that the free allocation could slow decarbonisation, and needs better targeting. Given that the European Commission accepted this recommendation, we expect the upcoming revision proposal to include options leading to full auctioning for all sectors.

Carbon market revenues should be used to for more climate action

According to the Commission report, revenues from the auctioning of ETS allowances exceeded EUR 14 billion in 2019 alone, and EUR 7.9 billion for the first six months of 2020.

While EU governments claim that a large part of these revenues is used for climate action, it is not currently legally required. The law only includes a non-binding provision that “at least 50%” of the auctioning revenues “should” be used for climate and energy-related purposes.

This is not good enough. Revenues from a climate tool must go in full towards driving more emission reductions which benefits society as a whole. Therefore, the Commission should propose 100% earmarking of all EU ETS auctioning revenues to climate action. Those revenues should go towards investing in renewable and energy-efficient technologies, clean industrial innovation, just transition and international climate finance.

Dealing with surplus

The market stability reserve (MSR), a mechanism that removes surplus allowances off the market since 2019, absorbed approximately three million allowances during its first year.

The MSR is a crucial instrument to stabilise the market and reduce price volatility. Thanks in part to this tool, after an initial crash, the ETS price has managed to withstand the shock caused by the Covid pandemic.

In the upcoming review, the instrument must however be strengthened. This will be particularly important in the second half of the next trading phase which potentially coincides with a big influx of allowances caused by the closure of coal-fired power plants across Europe. To deal with the current and future shocks, the rate at which the MSR withdraws allowances from the market should be increased to 36% (from current 24%).

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Airlines continue to benefit from pollution subsidies

Aviation emissions continued to rise, by 1% in 2019. Around half of these were covered by free allowances. Free pollution permits for the sector are another form of government subsidy to a sector which pays no fuel taxes nor VAT on tickets. Since the beginning of the pandemic, European airlines have also secured nearly €30 billion in bailout packages with little or no environmental conditions attached.

Through the upcoming ETS revision, the EU will have to review the aviation sector's coverage under the ETS and decide how to combine it with the implementation of CORSIA, the UN's new offset scheme covering international aviation. While the EU carbon market has its shortcomings, CORSIA has no climate credibility, in particular, since the aviation lobby managed to push through a rule change that will effectively postpone its start by years. Therefore, it cannot replace any parts of the EU ETS. On the contrary, the EU must strengthen its carbon market also for aviation by ending the free allocation.

The sector is going through difficult times due to a drop in demand as a result of covid-19. But it is important to keep in mind that prior to the pandemic its pollution growth trajectory was completely incompatible with keeping global heating at manageable levels. Previous crises have shown that aviation bounces back and so does its pollution if nothing is done. This pollution, we cannot afford.