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EU emissions trading system: free allowances must be better targeted, say auditors

Free allowances still make up over 40 % of all available allowances under the EU's 'cap and trade' emissions trading system (ETS), according to a new report by the European Court of Auditors (ECA). These free allowances, distributed to industry, aviation and, in some Member States, the electricity sector, were not well targeted. In addition, the speed of decarbonisation in the power sector was significantly reduced. The Commission needs to update its procedure for targeting free allowances to reflect the Paris Agreement and recent developments.

In principle, under the EU's ETS, a price is put on carbon emissions and emission allowances are auctioned. Auction receipts also provide revenue for climate action. The EU's ETS uses free allowances to discourage EU businesses from transferring activity to non-EU countries with lower environmental standards, as this would reduce investment in the EU and increase global emissions. This is known as "carbon leakage". The industrial and aviation sectors benefit from free allowances, unlike most operators in the power sector, as it is considered that they can pass on carbon costs directly to the consumer. However, in the eight Member States with a GDP per capita below 60 % of the EU average, the power sector received free allowances to enable modernisation to take place.

"Free allowances should be targeted at those industrial sectors least able to pass on carbon costs to consumers," **said Samo Jereb, the ECA Member leading the audit**. *"However, this is not the case. Sectors representing over 90 % of industrial emissions are equally considered at risk of carbon leakage and benefit from continuous high rates of free allowances. Unless the allocation of free allowances is better targeted, the EU will not reap the full benefits the ETS could have on decarbonisation and public finances*."

The auditors found that the power sectors that received free allowances to invest in modernisation made significantly slower progress in decarbonisation than other Member States. The investments were often used to improve existing lignite and hard coal power stations rather than moving to less polluting fuels, particularly in Bulgaria, Czechia, Poland and Romania. The auditors acknowledge that the Commission has tightened rules affecting the power sector for 2021-2030.

Free allocation of allowances to industrial sectors is based on benchmarks from each sector's top performers. The allowances will be progressively phased out by 2030 unless the sector is considered to be at risk of carbon leakage; in which case the allocation will not be reduced. While this approach provides incentives for improving energy efficiency, the auditors consider that better targeting is needed. The industrial sectors considered at risk of carbon leakage still represent over 90 % of EU industrial emissions, with no differentiation between different levels of risk, enabling all these sectors to continue to benefit from the full amount of free allowances. The auditors recommend that the Commission target free allowances based on exposure to different levels of risk.

Furthermore, the aviation sector receives free allowances despite being able to pass on carbon costs to customers. The auditors warn that this could support carbon-intensive air travel to the detriment of rail transport.

Due to the lack of targeting, under current arrangements most free allowances will not be reduced to zero by 2030. The auditors argue that more targeted distribution would have addressed the risk of carbon leakage, reduced windfall profits and benefited public finances by increasing the proportion of allowances auctioned.

Notes to Editors

Under the EU's ETS, the industrial, power and aviation sectors must obtain enough allowances to cover their carbon emissions. The system was set up in 2005 and EU per capita emissions have fallen since, but are still above the world average. In the system's first two phases (2005-2012), almost all allowances were allocated for free; and the number of allowances allocated was greater than the amount needed to cover actual emissions. A surplus of allowances built up. During phase three (2013-2020) this systemic over-allocation was largely eliminated. Between 2013 and 2020, over 6.66 billion allowances were allocated for free and the price of allowances fluctuated but increased from less than €3 to around €25 per tonne of CO_2 equivalent emitted. Between 2012 and mid-2019, Member States received €42 billion in auction receipts. If more allowances for industry had been auctioned, they would have received significant additional revenue. Phase four of the ETS runs from 2021-2030.

The auditors examined whether the free allocation of allowances was successfully used to modernise electricity generation, whether targeting was sufficient to provide incentives to reduce GHG emissions and whether free allocation had contributed to increasing emissions. At its special meeting in July 2020, the European Council invited the Commission to make a proposal to revise the ETS. The audit did not cover the impact of the COVID-19 pandemic on the ETS.

The ECA special report 18/2020, "The EU's Emissions Trading System: free allocation of allowances needed better targeting", is available in 23 EU languages at eca.europa.eu. In recent years, the ECA has published several reports on energy and climate, addressing topics such as vehicle emissions, solar and wind power and the ETS.

Information on the measures the ECA has taken in response to the COVID-19 pandemic can be found here.

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