Connie Hedegaard a former EU climate commissioner and Pascal Lamy a former EU trade commissioner and WTO director-general write on topic of ETS subsidies and EU climate targers.

Taken together, a reformed EU Emissions Trading System alongside a first-of-its-kind carbon border levy has the potential to be one of the world’s most powerful climate mitigation tools and promote positive global discussion about industrial decarbonisation.

But a successful delivery of these closely-linked policies is at risk unless the EU removes damaging pollution subsidies for industry – otherwise known as free ETS emissions allowances – when it publishes proposals on July 14 as part of its package to cut over half of all greenhouse gases by the end of the decade.

The whole idea of the ETS has been to drive the low-carbon industrial transition, requiring emitters to pay for their emissions above a certain ceiling by buying auctioned allowances to emit. Industry was provided with what was supposed to be an initial cushion or support in the form of a free allocation of allowances, covering the lion’s share of their emissions. This was intended to allow the system to get established and prevent so-called carbon leakage, whereby cheap high-carbon imports displace domestic production or EU producers move offshore to avoid carbon pricing.

But in the 15 years since the inception of the ETS, the vast majority of emissions reductions have come from power generation – a sector which hasn’t received free allowances since 2013. Emissions from industry meanwhile, which has continued to receive these subsidies, have largely stagnated, falling just 1% between 2012 and 2018.

Far from being incentivised to decarbonise, industry has successfully passed ETS costs onto consumers while making substantial windfall profits from free allocations. With many companies receiving an allocation greater than their emissions, firms were able to sell off surplus permits – pocketing up to €50bn to date according to some estimates. This is a huge problem given that direct industrial emissions alone account for around 16% of the bloc’s total GHGs. Rather than underpinning the core “polluter pays” principle of the ETS, free allocation has undermined it as well as perhaps tarnishing the EU’s climate credibility in the process. While this has also deprived EU governments of potentially huge sums to further climate action these are by no means the only reasons to rapidly phase out free allocation.

The carbon border levy is supposed to replace free allocation as the main tool for those industries most at risk of carbon leakage – likely electricity, iron, steel, aluminium, cement and fertilisers according to a leak – ensuring that domestic producers aren’t disadvantaged as they face higher pollution costs arising from the ETS emissions cap being progressively tightened.

However, there has been intense lobbying from some industry groups to maintain free allowances alongside the levy, and even for EU exporters to receive a rebate on their ETS costs. Assertions that a carbon border on its own would render industry uncompetitive sit uncomfortably alongside what we know. Nevertheless, leaks suggest a part of industry may at least partially get its way. This creates a number of further problems.

Chief among these is that there needs to be some degree of acceptance from international trading partners if the carbon border is to be successfully implemented. We have seen from the furore that met EU plans in 2012 to extend the ETS to flights into and out of the EEA that the bloc needs to take this issue seriously: the EU was ultimately forced to withdraw the policy. While the EU needs to do a better job of engaging with these partners, it is already clear that many would regard the existence of free allocation alongside the levy as a “double protection” providing them with a rationale for retaliation. This is in addition to protectionist concerns arising from the EU identifying carbon border revenues as an “own resource” – rather than being targeted at international climate efforts – undermining Europe’s desire to explain the reasonable intention of the policy.

The same issue presents a very likely contravention of WTO rules and would probably see challenges mounted, which if successful would be used to justify other retaliatory trade moves, including tariffs.

That such tensions could persist and ultimately lead to a trade war would not only damage the EU’s climate leadership and the multilateral spirit of climate negotiations but could also threaten to bring the carbon border crashing down. And without a serious Plan B for carbon leakage that would in turn threaten ETS reform.

A resulting failure to deliver on these twin policies would see the EU missing its pledge of reducing GHG emissions by 55% by 2030. This in turn would move the aim of net zero emissions by mid-century out of reach. Not only would that be a major domestic failure, it would have grave global ramifications.

If the EU is to avoid this potential fate, industry’s addiction to fossil fuel subsidies in the form of emissions allowances must be brought to a rapid end.

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