CARBON MARKET WATCH

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Free Allocation Regulation (FAR) revision

Carbon Market Watch's Feedback

The Free Allocation Regulation (FAR) revision is a necessary step to ensure the last years of the free allocation system are coherent with the aim of a full phase-out by 2030 (or 2034 for CBAM sectors) and provide the investment signals necessary to funnel funding into industrial decarbonisation.

For these reasons, Carbon Market Watch (CMW) does not endorse the Free Allocation Regulation in its current version. After attentively following the process for its revision within the Climate Change Policy Expert Group over the past months, we witnessed the watering down of the text leading to an increase of free allowances to incumbent industrial sectors. In its current shape, the FAR contradicts the political mandate given to the European Commission during the last review of the EU ETS Directive. **CMW therefore calls for the rejection of the FAR proposal as currently drafted**.

We recognise the European Commission proposed some improvements in ensuring rules for free allocation of emission allowances are supportive of less carbon-intensive production processes and ensure the "polluter pays" principle is gradually implemented in full (results of this ambition can be seen in the rules for hydrogen benchmarking that are now more favourable towards green H2, the now "aggregated" sintered ore benchmark, and the inclusion of hydraulic binders in the clinker benchmarks). At the same time, several key aspects of the draft regulation fall short of delivering the needed push for more environmental efforts from sectors that bear the most responsibility for GHG emissions.

Below is a summary of the key issues within the FAR that need to be urgently addressed.

Steel benchmarks - Annex I

The sectoral benchmarks are not reflective of the "one product = one benchmark" principle, but are instead linked to production processes.

- While the Commission decided to change the Sintered Ore benchmark into an Agglomerated Iron Ore benchmark (arguably the most ambitious change in the revisioned FAR), steel is still benchmarked in terms of hot metal/DRI instead of flat steel output: a missed opportunity for reduction of GHG emissions and for circular re-use of scrap.

Cement benchmarks - Annex I

The European Commission is well aware that reducing the clinker content is the best way to reduce cement emissions, however they did not want to create an all-encompassing cement benchmark.

- In the current proposal, benchmarks are still expressed in tons of (white or gray) clinker; with alternative hydraulic binders added. This is a very small improvement, because most supplementary cementitious materials (SCMs) will not fall within the scope of the revision and will be penalised. Technological innovations that effectively lower the most polluting component of cement manufacturing will not be supported by this regulation.

Historical Activity Level (HAL) - Art. 15 para. 3

The current ETS Free Allocation Regulation ((EU) 2019/331), the Regulation on adjustments to free allocation due to activity level changes ((EU) 2019/1842) and the Benchmarking Regulation ((EU) 2021/447)) all rely on the calculation of historic activity levels by calculating the arithmetic average of annual production. The Commission creates regulatory inconsistency by proposing to calculate it using a median level of annual production instead of the average. More importantly, this change would exclude the impact of years of lower production linked to the pandemic and the energy price crunch leading to unnecessary overallocation of free allowances beyond what's needed to cover current production levels.

Heavy industries already benefited from over-allocation of allowances in 2020. Sectors deemed at risk of carbon leakage received free allowances covering 104,5% of their emissions, leading to windfall profits. Those profits from excess FAs show there is no justification to allow the pandemic period to be less relevant in the calculation, let alone to rule them out altogether. Apart from creating windfall profits, maintaining an artificially high level of FAs allocation will trigger a higher application of the cross-sectoral correction factor (as per Article 10a(5) of the ETS Directive).

Process emission value - Art. 16, para 2 point (e)

Free allocation for process emissions not covered by product benchmarks is based on the grandfathering of historical emissions. The reduction level of free allowances for the sectors concerned -at 97% of historical emissions- has been unchanged since 2013. The current draft proposes a very lenient reduction value of 91% with enforcement only starting in 2028. This renders the revision of the process emission factor largely inconsequential and ineffective - especially considering earlier proposals by the Commission to lower it to 79%. Failure to update this value significantly will undermine decarbonisation of heavily polluting production processes, and create an uneven playing field by artificially maintaining the amount of free allowances to those non-benchmarked products.

In summary, we believe the European Commission falls significantly short on its mission as 'guardian of the treaties' to uphold the principle that the polluter should pay (Article 191(2) of TFEU)). Without changes to the current draft, Carbon Market Watch calls on the other EU institutions to act responsibly and reject the delegated regulation.

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