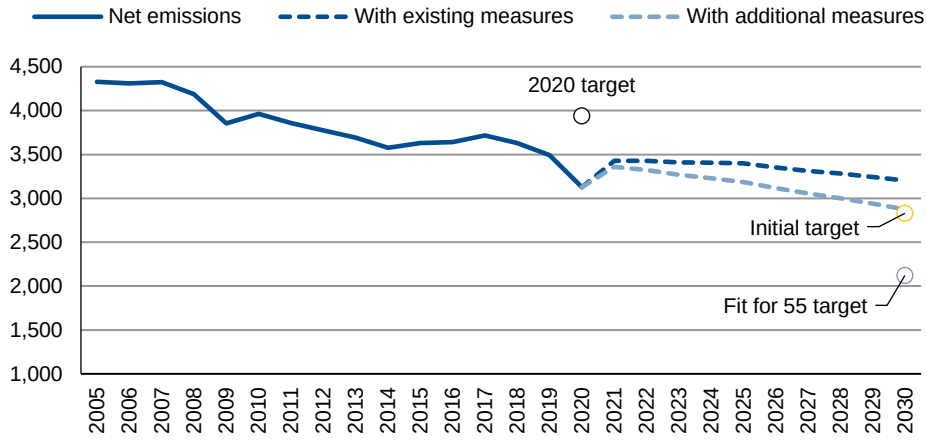
EU climate goals: few countries on course to be “Fit for 55”; further reforms needed

The EU (AAA/Stable) has set increasingly ambitious climate targets in recent years, but it will miss them without tougher climate policies and ramped-up investment – at a regional and national level – to accelerate emissions cuts. Failure to align individual member states’ climate action with EU objectives and set the foundations for sustainable growth constitute an important long-term risk to sovereign credit ratings.

The consequences of inaction are severe, with the potential economic, financial and social costs of a disorderly transition estimated by the ECB at around 25% of GDP by 2100[1]. We capture these environmental risks in our Sovereign Rating Methodology (see Appendix I).

The EU’s July 2021 ‘Fit for 55’ package, increased the greenhouse gas (GHG) emissions reduction target to at least 55% by 2030 versus 1990 levels, from the previous 40% target. The EU is revising its climate legislation including the Emissions Trading System (ETS) and Effort Sharing Regulation (ESR). Still, national policies are lagging. Even if current climate plans are implemented, the EU will miss its target by 753MtCO$_2$e (15% of 1990 emissions, **Figure 1**).

Figure 1: The EU 27’s net emissions targets and trajectories
MtCO$_2$e



Note: MDP = modelled domestic pathways; FS = based on fair share contributions.
Source: Climate Action Tracker, EEA, Scope Ratings

The main takeaways from our analysis are:

- Only two EU member states (Greece and Portugal) are on track to meet the Fit for 55 targets while 18 countries’ plans are insufficiently ambitious to meet EU targets.
- The EU still needs to address structural imperfections in its climate policy frameworks, among them, ESR flexibilities, incomplete carbon taxation, lax enforcement mechanisms, and the oversupply of (free) ETS allowances to meet its targets.
- This presents a considerable hurdle in a context of deteriorating macro-economic conditions, rising interest rates and more challenging national political landscapes.

As such, EU-level instruments should be mobilised more to spur national climate action, mitigate pressure on public finance, and demonstrate global climate leadership, supporting sovereign creditworthiness longer-term.

[1] ECB (2021), Economy-wide climate stress test

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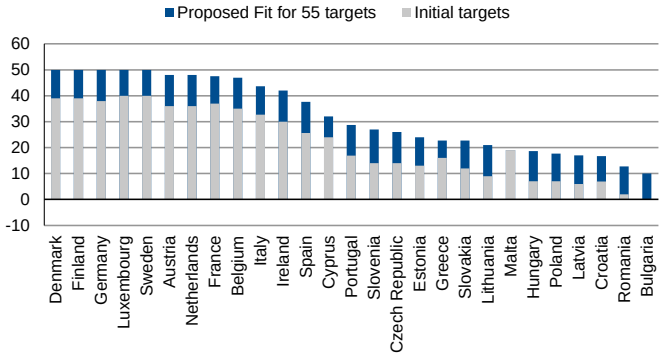
EU climate goals: few countries on course to be “Fit for 55”; further reforms needed

Several EU countries are due to miss their Effort Sharing targets

Increased stringency in ESR

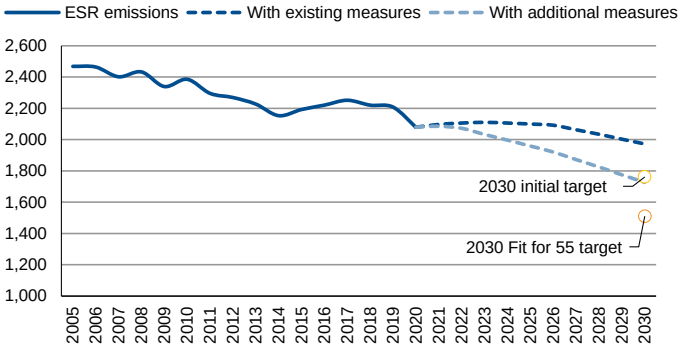
The ESR constitutes a major pillar of the EU’s climate strategy for sectors not covered by the ETS. As part the Fit for 55 measures, the EU-wide ESR emissions reduction target will increase from 30% to 40%. The EU thus proposed a revision to national emissions targets, increasing the level of ambition required of member states (**Figure 2**). While the increased ambition is a welcome development, there is a growing gap between EU-level objectives and national-level climate policies.

Figure 2: National ESR emissions reduction targets
% of 2005 emissions



Source: European Commission, Scope Ratings

Figure 3: EU-wide ESR emission allocations and targets
$MtCO_2e$



Source: EEA, Scope Ratings

National climate action is falling short of revised targets

In 2020, three countries, Cyprus (BBB-/Positive), Ireland (AA-/Stable), and Malta (A+/Stable), missed their ESR targets despite the substantial favourable effects of the Covid-19 crisis on emissions[2]. The ESR emissions of Germany (AAA/Stable), Malta and Ireland exceeded their national annual allocations over 2013-20. Projections[3] show that the EU will fall short of its initial ESR emissions reduction target by $176MtCO_2e$ (7% of 2005 ESR emissions) unless planned climate measures are implemented nationally (**Figure 3**). Even with all planned measures, the EU will miss its Fit for 55 ESR target by $165MtCO_2e$ (7% of 2005 emissions) under current plans.

A brief overview of the EU climate architecture

The EU climate strategy is based on the twin pillars of regulation and market-based incentives:

- **The Emissions Trading System** (**ETS**) is a market-base mechanism, which limits emissions in sectors including the energy, heavy industrial and commercial aviation sectors (around 40% of total EU emissions) through gradually declining caps and allowances.
- **The Effort Sharing Regulation** (**ESR**) is a governance tool, which sets binding annual greenhouse gas emission targets for member states in sectors not covered by the ETS (around 60% of emissions). The ESR specifies an overall GHG reduction target but does not specify where, how and with what policies. The choice of measures is therefore the responsibility of national governments.

The governance of EU climate policy hinges on integrated national energy and climate plans (NECPs) covering 10-year periods starting from 2021-30. The NECPs contain details on existing and planned measures in energy efficiency, renewables, emissions cuts, power grid development, and research and innovation, to achieve national climate goals. These frameworks are complemented and supported by EU-wide, sector-specific standards, regulations, and directives for instance in renewable energy, the automotive sector, or energy taxation. This multilateral policy architecture is critical to ensure consistency of and coordination in climate policies across member states as well as supporting a just transition.

[2] EEA (2022), Trends and projections in Europe 2022
[3] These projections are from 2021 and do not consider latest policy announcements by national governments.

Wide divergence among EU member states

Emissions projections submitted by member states in 2021 reveal a wide divergence across countries (**Figure 4**). Without considering ESR flexibilities, only two countries (3.9% of EU ESR emissions), Greece (BB+/Stable) and Portugal (BBB+/Positive) are expected to meet their Fit for 55 targets under current policies, nine (16.1%) can meet them only if they implement all planned measures, while sixteen (80%) will miss their Fit for 55 targets even with additional measures. We identify the following five categories:

Figure 4: Target practice – which EU member states are on track to meet ESR targets?
(% of 2020 EU ESR emissions)

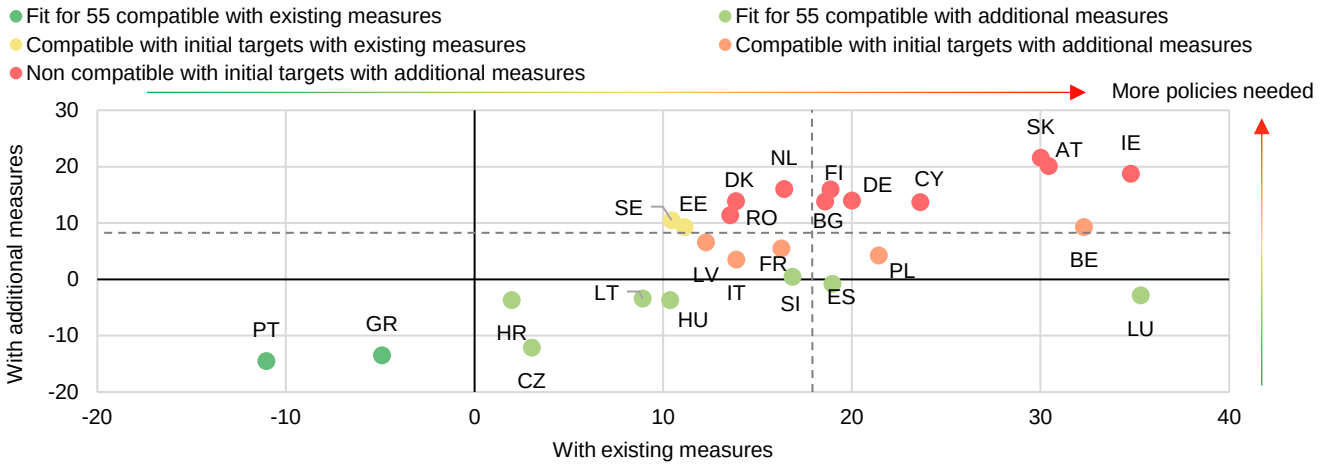
Most ambitious ← → Least ambitious

Fit for 55 compatible		Compatible with initial targets		Non compatible
With existing measures (3.9%)	With additional measures (16.1%)	With existing measures (1.8%)	With additional measures (40.4%)	With additional measures (37.9%)
Greece (2.0%)	Croatia (0.8%)	Estonia (0.3%)	Belgium (3.2%)	Austria (2.2%)
Portugal (1.9%)	Czech Republic (3.1%)	Sweden (1.5%)	France (14.8%)	Bulgaria (1.3%)
	Hungary (2.1%)		Italy (12.2%)	Cyprus (0.2%)
	Lithuania (0.7%)		Latvia (0.4%)	Denmark (1.4%)
	Luxembourg (0.4%)		Poland (9.7%)	Finland (1.4%)
	Slovenia (0.9%)			Germany (20.1%)
	Spain (8.6%)			Ireland (2.1%)
				Malta (0.1%)
				Netherlands (4.3%)
				Romania (3.7%)
				Slovakia (0.9%)

Note: Based on emissions projections submitted to the EEA in 2021. This categorisation does not consider ESR flexibilities.
Source: Scope Ratings

On average, the gap between projected emission cuts and the Fit for 55 targets is substantial at 17.9% of 2005 emissions under current policies and 8.2% with planned policies (**Figure 5**). Countries with the largest gaps with additional measures include Malta, Ireland, Austria (AAA/Stable), and Slovakia (A+/Negative). Current policies in Belgium (AA-/Stable) and Luxembourg (AAA/Stable) will lead to wide gaps as well but they have put forward plans that will help substantially reduce them, with Luxembourg even expected to outperform its target.

Figure 5: Project change in ESR emissions vs Fit for 55 targets, 2005-30
% of 2005 emissions



Note: Based on emissions projections submitted in 2021. Malta is an outlier and is excluded from this chart for legibility.
Dotted lines cross at the EU averages
Source: EEA, Scope Ratings

Carbon pricing is still not sufficiently mobilised

The emissions reduction strategies vary across member states with a mix of sectoral and

cross-sectoral measures. Several countries such as Luxembourg and Ireland intend to make increased use of carbon taxes, which are still not widespread in the EU or have too low rates[4]. Only 14 EU countries currently have a carbon tax with an average rate of EUR 35/tCO_2, well below the rates needed to incentivise effective transition in line with the Paris agreement, estimated at EUR 50-100/tCO_2[5].

Transport emission cuts to contribute the most to climate goals

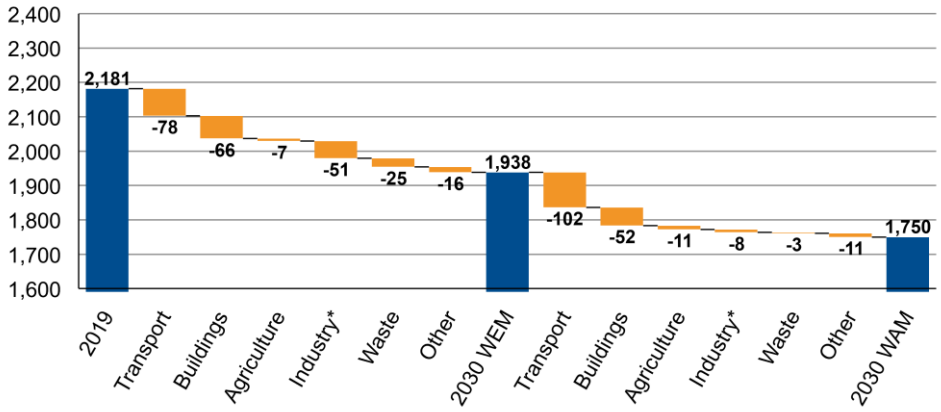
Many countries focus on reducing transport emissions, which is the largest non-ETS source of GHG and presents the greatest challenge for member states given the rising energy consumption of the sector (9% increase over 2005-20). Over 2019-30, the transport sector is expected to contribute 42% to EU-wide ESR emissions cuts with additional measures, followed by buildings (28%) and industry (15%, **Figure 6**).

ESR flexibilities hamper profound change

These projections do not consider the flexibilities that member states have under the ESR (see Appendix II for an overview of ESR flexibilities). Importantly, some countries can access large amounts of ETS allowances to offset emissions in ESR sectors. The projected transition trajectories of Austria, Belgium, Denmark (AAA/Stable), Finland (AA+/Stable), Ireland and Luxembourg would be compatible with Fit for 55 targets thanks to this flexibility.

However, ESR flexibilities hamper profound structural and behavioural changes and delay climate action. Specifically, the use of ETS credits could lead to higher ESR emissions without a commensurate decline in ETS emissions given the structural oversupply of ETS allowances (see following section). If countries were to use ESR flexibilities to the largest extent, the EU gap with its 2030 ESR goals could increase by up to 7pps[6].

Figure 6: EU wide ESR emission cuts per sector
$MtCO_2e$



* Industry includes energy supply and product use. WEM = With existing measures; WAM = With additional measures.
Source: EEA, Scope Ratings

Risk of insufficient national-level climate reform

Most EU countries will need to increase the ambition of their climate policies substantially to comply with the Fit for 55 targets. Some countries such as Germany have put forth more ambitious climate plans since the projections presented above were made, which will help move emissions closer to the EU’s ESR targets. Still, an important risk to ESR emissions reduction is that national governments fail to implement the needed policies to achieve their targets. Lack of broad political consensus and willingness to act on these

[4] European Environmental Bureau (2021), A carbon pricing blueprint for the EU
[5] High-Level Commission on Carbon Prices (2017), Report of the High-Level Commission on Carbon Prices
[6] Transport & Environment (2021), Fit to lose the climate challenge: How the ESR/CARE’s trajectory, flexibility and loopholes hollow out the climate targets.

issues, as well as fragmented parliaments or popular pushback are increasingly weighing on reform momentum.

Given these challenges and in view of past issues with ESR compliance, a stronger enforcement mechanism is needed to ensure commensurate corrective action is taken if a member state is not making sufficient progress. This can include increased public accountability for why member states are not meeting their targets, making access to ESR flexibility contingent on corrective action or greater monetary penalties.

Raising the ambition of the Emissions Trading System

ETS is an effective policy tool for incentivising transition

The EU ETS is a crucial market-based mechanism providing financial incentives to cut emissions. Since it launched in 2005, ETS emissions have fallen by around 43%, already in line with the initial 2030 target a decade in advance.

The ETS presents an important advantage over the Effort-Sharing Regulation. Once EU member states agree on the gradual cap reduction, the long-term transition path for covered sectors is set, which limits the risk of political backpaddling at the national level. By design, the decline in the cap and associated financial incentives should support progress towards climate targets regardless of the policy mix. Still, economies’ competitiveness could deteriorate if transition in ETS sectors is not adequately supported by national policies and funding.

Structural oversupply of allowances

The ETS suffers from structural oversupply of allowances which has led to an accumulation of a large allocation surplus in 2008-13 (**Figure 7**). This held prices down until 2019, when the EU introduced the Market Stability Reserve (MSR), a mechanism aimed at limiting the number of allowances in circulation exceeding a threshold of 833m. Since then, carbon prices have increased substantially to levels that support cost-effective carbon reductions (**Figure 8**).

Still, the surplus remains large and well above the threshold, at 1,308 $MtCO_2e$ in 2020, amounting to one year of ETS emissions. In addition, the 833 million allowance threshold - which was originally set to allow power companies to hedge their positions - is too high given that it was set when the United Kingdom (AA/Stable) was still part of the ETS and the European power sector was more carbon intensive.

Figure 7: ETS allowance supply, emissions and surplus
$MtCO_2e$

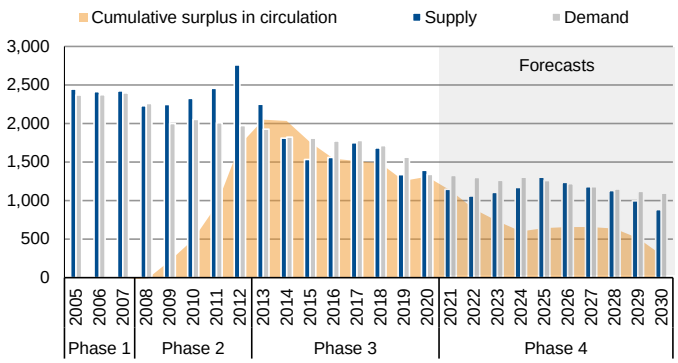


Figure 8: ETS allowance prices
EUR per tCO_2e

Note: Forecasts are taken from analysis by Sandbag.
Source: EEA, SandBag, Scope Ratings

Source: Bloomberg, Scope Ratings

Heavy industry and aviation are not cutting emissions sufficiently

The divergence in emissions across ETS sectors is another challenge. Virtually all ETS emission reductions achieved in recent years are due to declines in the electricity and heat sectors. Emissions in heavy industry have been broadly flat while they have even

increased rapidly in aviation (**Figure 9**). Industrial and aviation sectors benefit from more free allowances, diminishing incentives for climate action. In 2020, most allowances for industrial installations in the manufacturing sector and EEA aviation were allocated for free, while most emissions allowances for fossil fuel combustion were auctioned[7].

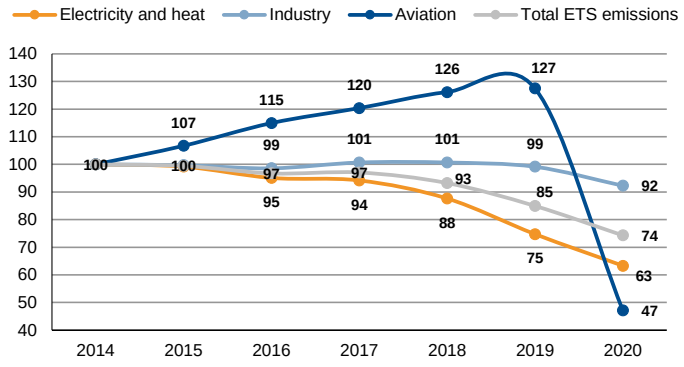
Free allocations hamper ETS effectiveness

Free allocations represented around half of total allocations on average over 2016-20 and the EU expects to continue providing 43% of allocations for free. Free allowances risk hampering ETS effectiveness. as they are distributed based on benchmarking exercises that often do not reflect industrial realities, contribute to the oversupply challenge, disincentivise important sectors from actively pursuing climate action and *de-facto* constitute a subsidy for Europe’s most polluting sectors[8].

Enhanced and broadened ETS under Fit for 55?

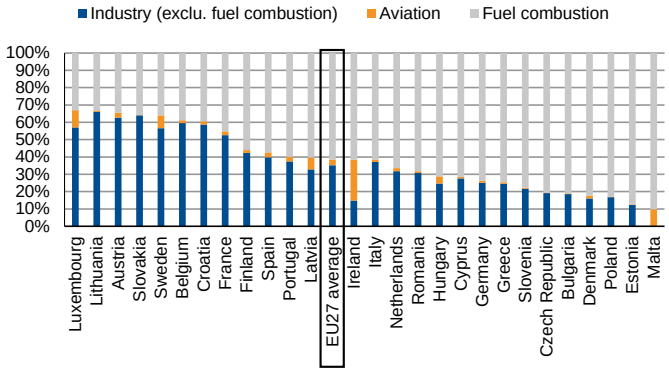
Under the Fit for 55 package, the EU has increased the ETS target to a 61% reduction via a lower emission cap and an increased annual reduction rate (2.2% versus the current 1.75%). In addition, the EU plans phase out free allowances for aviation but will continue providing them to industry. The EU also plans to broaden emissions trading to road transport and the buildings sector either as part of the existing ETS or via a parallel scheme. This could help avoid lagging national reform momentum in important ESR sectors.

Figure 9: Emissions across ETS sectors
2014 = 100



Source: European commission, Scope Ratings

Figure 10: Composition of ETS emissions per member state
% of total ETS emissions



Source: EEA, Scope Ratings

Sectoral composition of emissions matters for feasibility of emissions cuts

Large-scale ETS emissions cuts will be challenging for countries such as Luxembourg, Lithuania (A/Positive), Austria; Slovakia (A+/Negative), Sweden (AAA/Stable), Belgium and Croatia (BBB+/Positive) for which industry and aviation account for over 60% of ETS emissions (**Figure 10**). It is crucial that member states implement policies and support investments in hard to abate sectors such as heavy industry and aviation to achieve ETS emissions cuts without losing competitiveness.

Oversupply and sectoral divergence are likely to remain an issue given current national decarbonisation plans for the energy sector via for instance the rollout of renewables, which are likely to accelerate under the REPowerEU Plan. As such, the ETS could be made more ambitious by ending free allowance provision, setting an even more stringent annual reduction rate, and reducing the threshold at which the MSR absorbs surpluses.

[7] ECB (2021), EU emissions allowance prices in the context of the ECB’s climate change action plan
[8] Jacques Delors Institute (2022), No more free lunch: Ending free allowances in the EU ETS to the benefit of innovation

Concluding remarks

The EU needs to demonstrate climate leadership…

The EU cannot fight climate change on its own. Other countries around the world will also need to play their part. However, the EU is the world’s third largest emitter, accounting for around 8% of worldwide GHG emissions, after China (26.8%, A+/Negative) and the United States (12%, AA/Stable), though its share in global emissions declined substantially in recent decades. Still, it is uniquely positioned to demonstrate that sustainable growth is possible and inspire similar action among global partners. Increased climate ambition at the EU-level is an important step in the right direction. But this will need to be matched will forceful national policies and largescale investments (to be explored in an upcoming Scope commentary).

…amid adverse economic, social and financial conditions

Governments will need to rapidly accelerate climate action which presents clear challenges given the pressure on public finances from multiple sources the Covid-19 pandemic, energy shock, the overall less favourable macro-economic outlook, and rising social tensions, not to mention rising government borrowing costs (see previous Scope comment). In addition, polarisation and fragmentation in national parliaments, the rise of climate antagonistic right-wing populist parties[9] and fragmented politics could hamper climate reform in important EU emitters such as France (AA/Stable), Italy (BBB+/Stable) or Poland (A+/Negative).

Securing important competitive advantages

Climate action can also help support EU competitiveness and secure long-term economic advantages. Early and proactive climate policies can help underpin crucial innovation in important sectors. Through well designed incentives and public sector support investments in new technologies, products and business models can both help the EU meets its climate goals but also develop competitive advantages in the technologies of the future.

EU policy frameworks can support national green initiatives

In this context, EU instruments should support green policies in member states. Setting more ambitious parameters in the ETS and ESR as well as addressing lingering imperfections that disincentivise forceful and timely climate action is critical. Consideration of further use of EU common resources to fund national climate initiatives should also be considered[10]. The Next Generation EU programme has demonstrated the ability of Brussels to galvanise climate action at the national level. Similarly, investments via the EUR 100bn Horizon Europe and EUR 375bn InvestEU programmes will drive climate innovation through increased R&D, enhanced infrastructure, and better skills.

Addressing the challenge of climate change will help bolster the resilience of EU economies, secure important competitive advantages, and place growth on a sustainable path. Conversely, inaction could result in a disorderly transition, with substantial economic, financial and social consequences, estimated by the ECB at around 25% of GDP by 2100[11]. Which path EU economies go down will have lasting implications for their long-term credit trajectories.

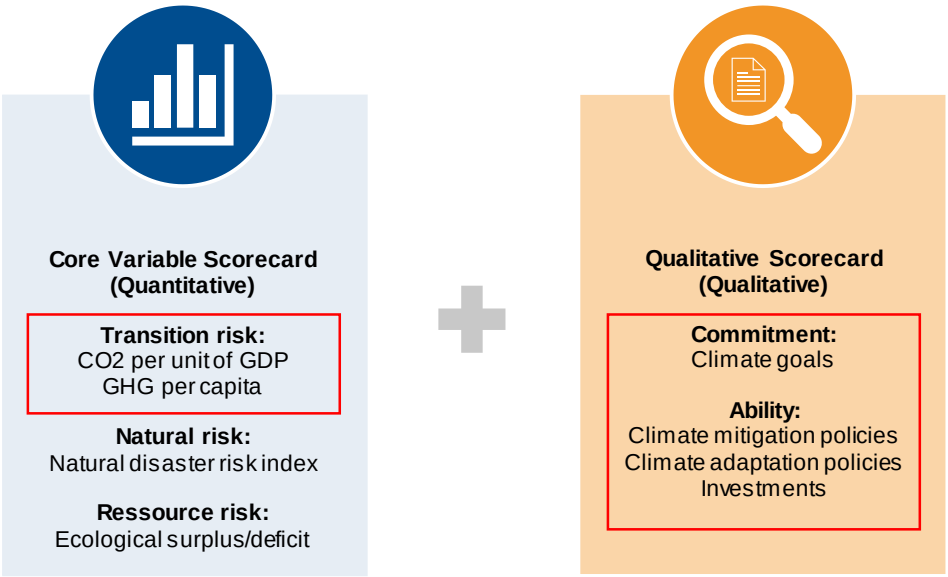
[9] Schaller and Carius (2019), Convenient Truths: Mapping the climate agendas of right-wing populist parties in Europe
[10] Garicano (2022), Combining environmental and fiscal sustainability: A new climate facility, an expenditure rule, and an independent fiscal agency
[11] ECB (2021), Economy-wide climate stress test

Appendix I. Incorporating climate mitigation into sovereign ratings

Since October 2020, our Sovereign Rating Methodology incorporates a quantitative and qualitative assessment of environmental factors that affect the credit profiles of sovereigns, with a 5% weight. We focus part of our analysis on transition risks which are critical for sovereign risk given the profound long-term impact they are likely to have on countries’ economic and financial systems as well as fiscal dynamics.

The quantitative model provides a snapshot of economies’ current carbon intensity while qualitative assessments capture our forward-looking view of governments’ commitments and ability to address environmental challenges. Countries’ climate objectives, policies and expected emissions trajectories are thus critical for our assessments.

Inclusion of environmental factors in Scope’s sovereign ratings



Source: Scope Ratings

Appendix II. Effort Sharing Regulation flexibilities

The ESR sets binding annual emissions reduction targets for each member state for the GHG emissions from the transport, building, agricultural and waste sectors. The contributions of each member state are based on its wealth as measured by GDP per capita. The ESR also recognises differences in the cost effectiveness of reaching national targets and provides some flexibility for member states as follows:

- **EU ETS allowances flexibility:** Nine member states (Austria, Belgium, Denmark, Finland, Ireland, Luxembourg, the Netherlands, Malta and Sweden) can use a limited amount of ETS allowances for offsetting emissions in ESR sectors. Countries’ can use a maximum of 2% of their 2005 ESR emissions annually over 2021-2030, except for Ireland and Luxembourg can use a limit of 4%. All countries will use their full amount except for Belgium (who will use 1.89%), Netherlands and Sweden (who will not use the flexibility).
- **Land use sector credits flexibility:** All member States can use up to 280m credits over 2021-2030 to comply with their national targets.
- **Banking, borrowing, buying, and selling:** Member states can bank surpluses from previous years to subsequent years (the entirety in 2021, up to 30% of annual allocations to subsequent years). Member states can also borrow from their allocations for the following year (up to 10% over 2021-25, up to 5% over 2026-29). Finally, member states can transfer their allocations to other member states (up to 5% over 2021-25, up to 10% over 2026-30).

The European Commission has stated that it intends to maintain all existing flexibilities under the planned revision of the ESR, deeming that the instruments are appropriate in scale and functioning.

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