

ERCST Report

EU ETS Review: Managing the EU ETS for decarbonization

Authors

*Andrei Marcu, Philippe Chauveau, Alexandra Maratou, Elizabeth Lesaulnier, Helen Bevernage,
Marco Sangiovanni*



This project was made possible by contributions from BASF, BDI, CEPI, Dow, EdF, ENEL, ExxonMobil, Metlen Energy & Metals, Norsk Hydro, PGE, Total Energies and Uniper.

The views expressed in this paper are those of the author and do not necessarily reflect the official policy or position of any of the funders.

EXECUTIVE SUMMARY

- The EU ETS is a central tool for decarbonization to reach EU climate targets, but industrial decarbonization, which is now the main focus, does not depend only on acting on the EU ETS price signal; it is also dependent on other external conditions not under the control of installations (KPIs) that are necessary, such as:
 - A market for low carbon products;
 - Availability of low carbon electricity and hydrogen at prices that are economical;
 - Infrastructure for electrification, hydrogen and carbon capture, transportation and storage.
- Conditions within the EU ETS, outside the EU ETS, and the stage in the decarbonization of the EU society and economy have changed. While so far, the EU ETS had to manage volumes to ensure an adequate price signal, it is now called to manage several additional dimensions:
 - Price and market functioning
 - Cost of compliance, including competitiveness
 - Managing flexibility for the introduction of CDR and international credits
 - Governance to enable the transition
- Changes envisaged:
 - Short-term: Changes internal to the EU ETS. These are changes that are necessary, but not sufficient, and which can and need to be introduced in the short-term to keep the EU ETS operational.
 - Medium to long-term: Changes to the Framework for decarbonization. These are changes that are necessary to ensure that the EU ETS can take us to the 2040 and 2050 target. They are changes that will articulate the EU ETS price signal with external conditions necessary for decarbonization, conditions that are not under the control of the installations.
- Managing these dimensions will, in the mid-to-long run, necessitate a flexible governance that will recognize the external KPIs outlined above, as these conditions cannot be met through simple mathematical formulae anymore. Many studies would suggest that the functions that are seen necessary would mimic that of Carbon Central Bank, but other forms such as an upgraded MSR may be considered. This would provide enhanced predictability and avoid one-off regulatory interventions, as well as the need for periodic reviews to the EU ETS regulations that result in step changes.
- Since introducing such a governance and ensuring that it has the trust of the market will take time, a workplan to develop and deploy it needs to be part of the outcome of the EU ETS review.
- Overall, ERCST believes that the EU ETS would be a better tool for decarbonization with the provisions in the Commission Proposal, but there are significant elements that need addressing, especially the conditionality in free allocation and the lack of a targeted provision for exports in CBAM covered sectors.
- Through proposing the introduction of investment conditionality, free allocation is now effectively labelled as a subsidy for decarbonization rather than carbon leakage protection. This is a significant change and departure from the DNA of the EU ETS. While maybe seen as well-intended by some stakeholders, conditionality does not seem to take into account that: a) free allocation is a cost reduction measure rather than a corporate financial handout b) while the power sector has achieved rapid decarbonization due to its lack of international trade exposure, the widespread availability of mature, low-carbon solutions and support (e.g. feed-in tariffs), heavy industry lacks these same structural advantages.

- Conditionality on having a decarbonization “plan” (as in a non-binding list of what could technologically be done at what time, subject to which enabling conditions, and how much would each step cost) may be conceivable. However, conditionality on making investments that don’t make sense economically should be a clear red line for the survival of EU industry.
- A two-step path can be envisaged to resolve the exports problem:
 - In the short term, reshape the transitional instrument already available around the logic of providing more targeted support for exports;
 - In the long term, provide a targeted exports solution in the form of non-tradable export adjustment (ERCST exports solution). We see this as the long-term destination, which requires an immediate start, to provide investors with the necessary visibility and confidence.
- While a new governance is examined and introduced, competitiveness and market functioning can be addressed by ensuring that free allocation is backloaded and phased down and not phased out. Our studies indicate a complementarity between free allocation and CBAM. This should be accompanied by other measures including adjusting the MSR parameters as well as ensuring the availability of free allocation and the avoidance of triggering the CSCF.
- Indirect cost compensation is critical for several industries.
 - Short to medium term: Maintain but harmonize indirect cost compensation across Member States;
 - Long term: Consider the creation of an EU-wide indirect cost compensation system.
- Provisions in the Proposal for the inclusion of CDRs, international credits, and recycling of revenue are welcome, but there are significant adjustments that this paper suggests.

Table of Contents

Introduction	2
1. Managing the EU ETS as a decarbonization tool	2
1.1. How the EU ETS is being managed now.....	2
1.2. Changing circumstances in which EU ETS functions	3
2. Initial reactions to the 2026 EU ETS Review proposal	4
3. EU ETS Strawman.....	6
3.1. Well-functioning market and price	7
3.2. Managing costs/competitiveness	9
3.2.1. Addressing costs from direct emissions.....	9
3.2.2. Addressing indirect costs	13
3.3. Managing flexibility for the introduction of CDR and international credits.....	14
3.3.1. CDRs	14
3.3.2. International credits.....	16
3.4. A governance framework for enabling the transition	16
4. Annex: Managing the EU ETS as a decarbonization tool.....	19
4.1. Managing principles of the EU ETS as a decarbonization tool.....	19
4.2. How the EU ETS is being managed now.....	20
4.3. Changing circumstances in which EU ETS functions	20
4.4. Post 2026 ETS management: what, how and who	21
4.4.1. EU ETS stability.....	21
4.4.2. EU ETS elements to be managed	21

Introduction

Following the Commission proposal that was put forward on July 17, 2026¹, this paper:

- Begins by briefly identifying what must be managed so the EU ETS can continue driving decarbonization amidst evolving circumstances (Chapter 1)
- It then provides ERCST's initial reactions to the Commission proposal (Chapter 2);
- The main part of this paper sets out ERCST's EU ETS Strawman (Chapter 3);
- Provides in an Annex, what ERCST sees as the elements that need to be part of the review of the EU ETS (Annex).

1. Managing the EU ETS as a decarbonization tool

The EU ETS carbon market is not a natural market, but a regulatory one, with a regulatory-determined scarcity. In setting the scarcity, several factors need to be considered, informed by atmospheric science.

While the EU ETS and the carbon price signal are central elements of EU climate policy, they are but one element that must come together with others to create a sustainable decarbonization and transition.

This calls for the **need to manage the EU ETS** and its relationship with other conditions necessary for decarbonization. Therefore, the EU ETS **is required to**:

- Be a well-functioning market with good price discovery - one that provides a signal for decarbonization and an incentive for clean investment (the price of EUA and the cost of compliance).
- Provide a signal that contributes to a sustainable transition – ensuring that the economic/competitive and social axes are moving at the same speed.
- The speed (signalled through EUA price/cost) cannot be decoupled from surrounding conditions and needs to be managed.

1.1. How the EU ETS is being managed now

The EU ETS has focused on managing the EUA price trajectory as there were concerns about the role of the EU ETS in decarbonization, given the price trajectory in Phase 2 and early Phase 3 (the price level was not enough to signal investments in decarbonization). Cost was less of a concern due to EUA price levels and the availability of free allocation.

¹ Proposal for a Directive amending Directive 2003/87/EC and Decision (EU) 2015/1814 as regards driving competitiveness and cost-effective decarbonization, COM(2026) 616 final

Price trajectory

- The MSR is the primary management tool of the EU ETS today and was introduced to manage the supply/demand balance and, through it, the EUA price trajectory.
- There was an evolution and change in the role of the MSR, which also played the role of a surrogate/primitive Carbon Bank as more features were added over time:
 - Modifying the cap through the introduction of the invalidation provision.
 - Releasing volumes to feed different financial streams such as the RePower EU and the Innovation Fund and to cater for new entrants' free allocations in phase 4.

Volatility

- Art 29a was intended to manage price volatility but was never triggered. Price trajectory and price volatility are two different concepts that should not be confused. The MSR manages the price trajectory, while the objective of Art 29a is to manage volatility, should it occur.

Cost of compliance

- The cost of compliance was largely managed through the provision of free allocation and indirect cost compensation (ICC).

1.2. Changing circumstances in which EU ETS functions

ERCST has examined in depth² the issue of changing circumstances under which the EU ETS functions and the transition takes place, in general. The issues below merit highlighting for the purpose of this discussion:

- Generalized EU ETS shortages annual shortage in the second half of 2020s and TNAC continuing to decrease to or below MSR upper threshold 0.8 bn EUAs. EUA prices are expected to enter new territory.
- As a result of the phase-out of free allocation, due to the introduction of CBAM, the hedging needs of industry are structurally transformed and rising.
- We are moving from the decarbonization of the power sector to decarbonization of heavy industry, in the context of increasing industry competitive pressures, due to decrease in carbon leakage protection, moving up the marginal abatement cost (MAC) curve, increased energy prices, trade measures, and over-regulation.
- Available public financial resources are more limited
- Upcoming concerns about liquidity in the EU ETS in the mid-to-late 2030s. While liquidity is not yet a problem today, with the current LRF and from the perspective of the trading community, it is likely to become a problem in the mid-2030s resulting in price volatility and not good market functioning.

² See Marcu, A., (2026), EU ETS Review: Issues and Levers, ERCST, April 2026 <https://ercst.org/eu-ets-review-issues-and-levers/>

2. Initial reactions to the 2026 EU ETS Review proposal

In its proposal the EC seems to have had a number of key parameters that it wanted to meet:

- Maintain the architecture, and especially the governance, of the EU ETS as is.
- The feeling that comes through is that all is good, we only need to adapt the EU ETS – this is an evolutionary proposal. There are however some very revolutionary changes happening around the EU ETS.
- Address, and be seen to address, concerns regarding the impact that the EU ETS has on competitiveness.
- Ensure that the 90% target for 2040 is protected.
- Maintain a strong environmental credibility with civil society in the EU, and globally.

In its previous work, including the paper that it released before EC proposal³, ERCST has emphasized several areas in which the EU ETS would need to be managed:

1. Price and market functioning
2. Cost of compliance
3. Managing flexibility for the introduction of CDR and international credits
4. Governance to enable the transition

The Proposal contains a number of provisions that can be seen as mimicking the management and flexibility that ERCST thinks necessary. Overall, ERCST believes that the EU ETS would be a better tool for decarbonization with the provisions in the Proposal. These are necessary, but in the long term not sufficient, provisions.

Provisions for the inclusion of CDRs, international credits, and recycling of revenue are welcome, even if one wonders why we only recycle 50% of revenue.

Conditionality was expected and will make the object of deeper analysis, but the conditionality that was outlined by ERCST (articulation of price and cost of compliance with external conditions) is only addressed through the hope that the money provided, good implementation of newly proposed complementary measures (e.g. electrification action plan), and the promise of future system updates (possible introduction of fallback benchmarks post-2030 that take into account sector-specific considerations or difficulties in decarbonization) will ensure that it is met. Requiring decarbonisation plans is an option that can be examined, however forcing uneconomical investments is not the right way forward. We believe that we would be better served by having clear KPIs to ensure that conditions are met, rather than provide money and hope for the best.

The proposal includes no permanent CBAM exports provision. The proposed extended free allocation phase out schedule for CBAM sectors does not resolve the exports problem. The extra free allocation is granted on production, with no link to export exposure, the same flaw as the Temporary Decarbonization Fund, so it dilutes support across all output instead of targeting exports. It also only defers the problem: free allocation still reaches zero in 2038, leaving exporters

³ ERCST (2026), Review of ETS – Managing the EU ETS for Decarbonization, <https://ercst.org/managing-the-eu-ets-for-decarbonization/>

with a residual carbon cost their overseas competitors don't face. The Commission has chosen the WTO-safe route of generic free allocation over a targeted, export-linked instrument, leaving the case for a dedicated, benchmark-based export adjustment intact (ERCST suggested solution).

The Proposal tries to introduce flexibility while maintaining the mathematical triggers. Nothing dramatic will happen in the short-term, but you can only square the circle so far. We believe that this will make one-off interventions inevitable as time will pass. The case for that can be made from the "one off", very specific provisions in the EU ETS and the Proposal, trying to foresee every scenario - a market impossibility. This transforms the EU ETS from a simple, efficient, market concept into an increasingly complex machinery, which only few can fully understand.

As foreseen, this provides temporary relief and solutions trying to foresee the future, but not a coordinated holistic approach and governance that can react to inevitable and unforeseen changes. It leads to an increasingly constrained EU ETS, moving further from the simple and efficient concept that is a market.

Overall, many of the right ingredients are in the Proposal, but the glue that would make the EU ETS able to provide a predictable and coherent response to what will be a difficult and unpredictable transition is missing. Such a change, which would involve a change in governance, will be presented by sceptics as administratively difficult (10 years for implementation is quoted often), without a political champion and support, and above all unnecessary. We would dispute all three arguments, since we have in the MSR as a primitive flexibility instrument that could be easily adapted. We can only hope that the legislative process will bring up a vigorous debate.

3. EU ETS Strawman

Since the introduction of the MSR which became operational in 2019, while nominally the MSR a volumetric control, the EU ETS had effectively in place a price management tool. Changes in the circumstances under which the EU ETS functions and the transition takes place, make it necessary to manage more than prices. What is more, a robust EU ETS review must deliver greater market and operational transparency as well as address all circumstances to ensure predictability.

Crucially, the EU ETS review timeline must not be rushed; it requires a measured, holistic approach that fully accounts for the cumulative impact of other pending proposals across the broader climate and energy governance framework.

In our work, ERCST has emphasized several areas in which the EU ETS would need to be managed⁴:

1. Price and market functioning
2. Cost of compliance
3. Managing flexibility for the introduction of CDR and international credits
4. Governance to enable the transition

For each of the above four areas, this chapter tries to provide concrete proposals and also differentiate between recommendations that can be implemented in the short-term and in the mid-to-long term as they require significant changes to the EU ETS.

Another way to look at it is to imagine issues, and proposed actions to address them, that can and need to be addressed in the short-term, that is, changes that are necessary now. The second category are changes that if not put in place now will not result in the EU ETS not functioning - they need to be seen as necessary, and in our view, inevitable. Not considering these changes will result, at best, in the need for one-off interventions, in an unpredictable manner, in the future.

Changes envisaged:

- Short-term: changes internal to the EU ETS. These are changes that are necessary, but not sufficient, and which can and need to be introduced in the short-term to keep the EU ETS operational.
- Medium to long-term: Changes to the Framework for decarbonization. These are changes that are necessary to ensure that the EU ETS can take us to the 2040 and 2050 target. They are changes that will articulate the EU ETS price signal with external conditions necessary for decarbonization, conditions that are not under the control of the installations.

⁴ See Annex to this paper for an updated version of the baseline of what ERCST sees as the elements that need to be part of the review of the EU ETS.

3.1. Well-functioning market and price

We need to continue ensuring good functioning of the market and price discovery for entities to manage business and compliance in the short term, as well as to ensure cohesion between the short-term market signal with the long-term price signal for incentivizing clean investment for decarbonization. Managing the supply-demand balance through volume-based elasticity of the supply is the approach retained for *managing the price trajectory*.

In the years to come, the market is expected to operate under an increasing scarcity of allowances available in the market, as characterized by TNAC, to the point of requiring releases from the MSR in the mid- 2030s.

At the same time, structural growth and changes in hedging patterns are expected to come from a new class, with installation in the CBAM sectors compensating for the phase-down of their free allocations , although volumetric impacts are hard to assess at this time. Since all covered sectors are now becoming buyers of allowances, the needs for installations to hedge are met with allowances available in the market and carried forward through buy-and-carry strategies of financial institutions.

The interplay between these factors requires the *management of increasing risks of excess price volatility on the upside* and protection from the damaging impacts on competitiveness, social cohesion, and the political credibility of the ETS. We believe that a rapid volume-based response is needed, if such situations develop.

Lastly, the reduction of the cap over time makes liquidity a potential concern for good market functioning in the mid-to-late 2030s. We see it necessary to *ensure maximum liquidity* with deliveries of volumes from sources outside the EU ETS: removals, international credits, and domestic credits.

Revise the MSR to manage the market and price trajectory

In the short term, since more complex systems take time to be developed, implemented and gain trust in the market, the MSR needs to continue with automated rules based on the TNAC KPI, a mechanism that already enjoys such trust. Its parameters need to be adapted to the new conditions of the ETS. It includes:

- Adapt the thresholds (upper and lower) and allow for the new or changing hedging needs. A separate ERCST study will include recommendations on the new levels.
- Introduce a buffer for releases with a set up similar to the buffer for absorption, for smooth releases when they are expected to start during the 2030s.
- Restore absorption rate to 12% in consideration of scarcity observed in today's market and expected to increase going forward. Current 24% rate was set when the market was very long.

In the mid-to-long term, the trajectory will be best managed with MSR evolving to a dynamic model for absorption and release, based on more KPIs than TNAC and operating under a flexible governance - putting in place functions that can manage more than just prices and that some see in a future embodied in an institution akin to a European Carbon Central Bank (what matters are functions and not the institution). Time to implementation procures the space required for building trust with market stakeholders. See more under section 3.4.

Invalidation of allowances must be removed now and in full. Allowances released from the MSR to the market do not change the EU ETS budget, and the MSR's firepower to release allowances and manage the price trajectory needs to be preserved. Expected in the late 2030s, annual market shortages may start to pinch earlier, depending on the timing at which conditions for releasing to the market the 400 million EUAs in IDB's Investment Booster are actually met by projects.

Adjust Article 29a for responding to excess price volatility

In the short term, the trigger factor for Article 29a needs to be lowered in consideration of the new price level of the ETS. A 2.4x factor is no longer fit for market prices 80€ and above. Price volatility is also better addressed with two time horizons, allowing for a faster response than under current provisions:

From ERCST's point of view this mechanism should be about price volatility and as such it should be a two-way mechanism. However, it has become obvious that the intent and support seems to be primarily to address the upside volatility as a priority.

- Set the trigger factor to around 1.5
- Release 25 million allowances if the average carbon price over the preceding 3 months exceeds 1.5 times the average price of the preceding year.
- Release 50 million allowances if the average price over the preceding 6 months exceeds 1.5 times the average price of the preceding two years.
- The mechanism can be activated twice within one year rolling period.

In the mid-to-long term, with the proposed introduction of a more flexible governance, management of price volatility should be under the same roof as the management of the price trajectory, currently being done by the MSR.

Maximum liquidity for good market functioning in the mid-to-long term

Ensuring the full and timely delivery of all removals and international credits permitted to enter the ETS will be critical to the proper functioning of the market and to maintaining a credible and robust price trajectory. Predictability regarding the volumes, timing and conditions under which these units enter the market will be equally important. See further discussion in Section 3.3.

The Commission will also need to move forward with the implementation of the provisions under Article 24a, which allow for the inclusion of domestic credits generated by projects that reduce or avoid emissions from activities not covered by ETS1 or ETS2. This represents an important, and

so far underutilised, element of the ETS architecture. Agriculture should be considered a priority sector, given both its mitigation potential and its current position outside the scope of the ETS.

3.2. Managing costs/competitiveness

3.2.1. Addressing costs from direct emissions

To manage direct costs, policymakers must leverage a number of critical tools, including: adapting free allocation rules—including benchmarks, conditionalities, and total free allocation headroom—and introducing a dedicated export solution for CBAM sectors.

Free allocation for CBAM and non-CBAM sectors

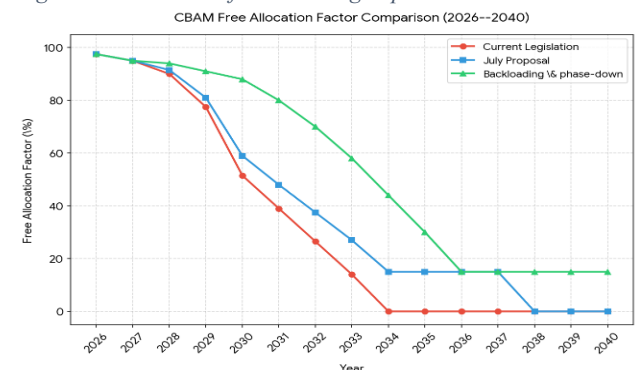
While non-CBAM sectors can and should continue to receive free allocation under the current carbon leakage protection framework, the EU officially treats CBAM and free allowances as substitutes for sectors covered by the Mechanism.

Notwithstanding, CBAM and free allocation operate through different economic channels: CBAM acts on marginal competitive conditions at the border, whereas free allocation affects profitability and balance-sheet constraints, which matter for survival and investment capacity in globally exposed industries. CBAM does not fully replicate the broader leakage protection historically provided by free allocation, notably for exports and complex value chains. A recent modelling study by ERCST and CEC demonstrated that keeping free allocation for CBAM sectors makes the transition significantly less disruptive⁵.

In that light, CBAM and free allocation can be seen more as naturally complements than substitutes in addressing leakage over the long run, and the phase out schedule for CBAM sectors should be adapted to maintain a “reasonable” level of free allocation:

- **Phase down rather than phase-out free allocation:** this would entail a partial adjustment of free allocation to non-zero, i.e. adjusting free allocation for CBAM covered sectors during a transitional period, but keeping in a non-zero level in the long run. The non-zero level, which could vary by sector, would aim to provide mitigation against remaining carbon leakage risk not covered by the CBAM, until its full effectiveness is proven.
- **Backload the phase out schedule** (slower in the beginning)

Figure 1 Illustration of backloading & phase down



Note: percentages of 'Backloading & phase down' curve are arbitrary/for illustrative purposes

⁵ Full paper: ERCST/CEC (2026). Carbon leakage under CBAM and free allocation. Joint ERCST CEC publication <https://ercst.org/carbon-leakage-under-cbam-and-free-allocation/>; Summary for Policymakers: <https://ercst.org/carbon-leakage-under-cbam-and-free-allocation-2/>

Free allocation investment conditionality

Through proposing the introduction of investment conditionality, free allocation is now effectively labelled as a subsidy for decarbonization rather than carbon leakage protection. This is a significant change and departure from the DNA of the EU ETS. While maybe seen as well-intended by some stakeholders, conditionality does not seem to take into account that: a) free allocation is a cost reduction measure rather than a corporate financial handout; b) while the power sector has achieved rapid decarbonization due to its lack of international trade exposure, and the widespread availability of mature, low-carbon solutions and support (e.g. feed-in tariffs), heavy industry lacks these same structural advantages.

Conditionality on having a “plan” (as in a non-binding list of what could technologically be done at what time, subject to which enabling conditions, and how much would each step cost) may be conceivable. However, conditionality on making investments that don’t make sense economically is a clear red line.

That said, we recommend to:

- **Remove the conditionality clause altogether (preferred option)**, as it strips away carbon leakage protection, places a strain on corporate liquidity and therefore competitiveness and introduces regulatory uncertainty that undermines investments.
- **Change the conditionality clause (second best)**: Failing a full withdrawal of conditionality, it must at minimum be amended in order to provide genuine incentive or minimize damage (by order of priority):
 - **Move to a positive conditionality** (= reward investment by providing additional free allocation)
 - E.g. 100% FA conditional on a plan + additional FA for delivering on plan
 - **100% free allocation up front and then 20% clawback** if conditionality is not met. Clawback not applicable if it can be demonstrated that the planned emissions reductions were not achievable because of external conditions. Clawback amount to go to IDB.
 - **Apply conditionality to part of free allocation**, e.g.:
 - E.g. apply it to 25% of a covered installation’s or producer’s total freely allocated amount
 - The additional free allocation stemming from the 2026 EU ETS review, compared to free allocation from current legislation.
- **Clearly define the types of expenditures that count towards meeting conditionality**: In addition, if conditionality is kept, Article 10a of the Directive should be amended to clearly define the types of expenditures that count towards meeting the equivalence of 100% economic value of free allocation in alignment with Recital (46) of the Commission proposal that stipulates that “*decarbonisation investments, [...] can include both capital expenditure (‘CAPEX’) and operating expenditure (‘OPEX’)*”, and further operationalise the concept.
- Couple free allocation conditionality with conditionality in meeting external KPIs (see section 3.4).

Create additional headroom for free allocation

To eliminate the risk of triggering the Cross-Sectoral Correction Factor (CSCF)—which according to the Commission’s impact assessment would be triggered as of 2031 and would apply in most years of Phase V⁶—, sufficient headroom for free allocation should be created, through:

- **Decreasing the LRF** (preferred option), expands the total system’s volume, thereby creating additional headroom for free allocation.
- **Reinstating invalidated EUAs to build a Free Allocation Strategic Reserve** and address structural scarcity. This Strategic Reserve can act as an automated secondary buffer to avoid triggering the CSCF.
- **A dynamic ratio between free allocation and auctioning.** Instead of maintaining a rigid percentage split between auctioning and free allocation, the system dynamically shifts allowances between the two based on market demand and industrial activity.

Adapt benchmark methodology

EU ETS benchmarks must remain representative and technically feasible. Under Article 10a(2) of the EU ETS, product benchmarks are determined on the basis of the average greenhouse gas efficiency of the top 10% most efficient installations in a sector irrespective of their production volume. This could lead to situations where the resulting benchmark is unrepresentative because:

- **Pioneering plants utilizing breakthrough technologies depress the baseline:** benchmarks are artificially pulled down by a single plant that deploys a highly advanced, often heavily subsidized breakthrough technology (e.g., green hydrogen or carbon capture) that cannot yet be replicated at scale.
- **Small low-emitting plants skew the count:** By defining the "top 10%" in terms of number of plants, a cluster of small, low-emitting plants can completely account for the "top 10%". Benchmarks can thus be dictated by a few "outlier" installations utilizing niche local energy sources (like localized biomass), or unscalable breakthrough technologies. The resulting benchmark becomes unrealistic for the rest of the sector.

To resolve this, the following 2 changes to the benchmark methodology can be envisaged:

- 1) **Temporarily exclude first-of-a-kind installations from the pool of installations determining the benchmarks** until the breakthrough technologies they rely on have reached a specific Technology Readiness Level (TRL) or market penetration threshold. There is a legal precedent of such exclusion in the EU ETS framework in the steel sector for the calculation of the hot metal benchmark⁷. The same approach could be expanded across all product benchmarks.

⁶ See ‘Table 21: Estimated CSCF under the different carbon leakage prevention measure of the total volume of free allowances available under the baseline and policy scenarios for 2031-40’, p 49 in SWD(2026) 616 final PART 4/5

⁷ Recital 49 of Directive (EU) 2023/959 explicitly excludes certain highly advanced or restructured plants from the calculation of the hot metal benchmark: “To incentivise new breakthrough technologies in the steel industry and to avoid a significantly disproportionate reduction of the benchmark value and in light of the particular situation of the steel industry such as the high emission intensity and the international and Union market structure, it is necessary to exclude from the calculation of the hot metal benchmark value for the period

- 2) **Shift to a multiple criteria approach (volume, plant count, and geography) to ensure representativeness:** Change the legal text of Article 10a(2) of the ETS Directive to introduce multiple criteria that would ensure a better representativeness of the benchmark setters. Under this approach, the Commission would rank installations by carbon intensity, but the pool of installations determining the benchmarks would only close once the ranked plants collectively account for a:
- i. **Minimum production volume share of the total EU output** for that product of e.g. 10%. This ensures that facilities that represent the true operational reality of the market are factored into the benchmark calculation, rather than letting a few niche plants dictate the rules for the whole sector.
 - ii. **Minimum number of installations** e.g., a minimum of 3 distinct facilities to avoid single-plant dominance.
 - iii. **Minimum geographic diversity** e.g., spanning at least 2 different Member States to eliminate localized or country-specific resource advantages.

Permanent exports solution for CBAM sectors

CBAM neutralises the carbon-cost gap on imports but leaves EU exporters exposed in third-country markets as free allocation falls to zero, with consequences for both competitiveness and carbon leakage⁸. A permanent export solution was expected but was not included in the EU ETS review proposal; instead, it gives CBAM sectors more generic free allocation, reinstating 15% of the amount otherwise removed by the CBAM factor from 2028 and extending the full phase-out from 2034 to 2038⁹. This buys time but is not an export measure: the support is untargeted, spread across all production rather than the exported share.

A two-step path is envisaged to resolve the exports problem:

- **In the short term, reshape the transitional instrument already available around the logic of providing more targeted support for exports:** redesigning the Temporary Decarbonisation Fund so that support is tied to export exposure and to ETS benchmarks. Similarly, part of Industrial Decarbonisation Bank funding can be steered towards the export-exposed installations to cut the carbon intensity that drives such exposure. Designed this way, the short-term measures reduce exposure at source and become stepping stones to the certificate's solution.
- **In the long term, provide a targeted exports solution in the form of non-tradable export adjustment certificates** (ERCST's exports solution): such certificates would be issued for exported volumes based on the cleanest-decile ETS product benchmarks and redeemable for allowances from under the cap, which offset exporters' residual carbon costs while preserving the incentive to decarbonize¹⁰. We see this as the long-term

from 2026 to 2030 installations that were operational during the reference period from 2021 to 2022 and that would otherwise be included in that calculation due to the review of the definition of the product benchmark for hot metal."

⁸ . Marcu, M. Mehling, A. Cosbey and S. Svensson, Review of Carbon Leakage Risks of CBAM Export Goods, ERCST, 2024, <https://ercst.org/review-of-carbon-leakage-risks-of-cbam-export-goods/>.

⁹ European Commission, Proposal for a Directive amending Directive 2003/87/EC and Decision (EU) 2015/1814, COM(2026) 616 final, 17 July 2026.

¹⁰ A. Marcu, M. Mehling, A. Cosbey and L. Fleury, Solutions for exports of EU CBAM-covered goods, ERCST, 2025, <https://ercst.org/solutions-for-exports-of-eu-cbam-covered-goods/>. The certificate design draws on ERCST's earlier proposal in Treatment of Exports in the EU CBAM, ERCST, 2022.

destination, which requires an immediate start, to provide investors with the necessary visibility and confidence.

Introduce flexibility for addressing costs

Introducing KPI-linked flexibility for addressing costs if the external condition KPIs (outlined in Section 3.4) are missed. In such cases, the following targeted interventions could be deployed:

- Increase free allocation volumes to offset unexpected cost exposure.
- Provide targeted funding or direct cost compensation to stabilize affected installations.
- Consider adjustments to current compliance obligations.

Auction revenue recycling and IDB

While we welcome the proposal's recognition of only a small share of revenues making it back to covered entities, the rules must be calibrated to better match the true scale of the transition:

- **Maximise revenue recycling:** Revenue recycling to EU ETS sectors should be maximised to 100%. Full earmarking better aligns funding with cost-exposure.
- **Provide early clarity on Investment Booster & IDB:**
 - To prevent an investment standstill, the Commission must promptly finalize the bank's operational terms and conditions and work programme and provide a vision with respect to the design features and scale of CCfDs. Industry requires immediate clarity on eligibility and award criteria to make long-term investment decisions.
 - Ensure both CAPEX and OPEX support is provided. This will vary by sector and technology maturity, as well as whether funded projects concern the decarbonisation of existing plants or investment in new low carbon assets. E.g. investing in CCS to decarbonise an existing facility will primarily require OPEX support/derisking, a new plant deploying a breakthrough technology will also require CAPEX support.

3.2.2. Addressing indirect costs

Maintaining indirect cost compensation is critical for protecting European competitiveness. Nonetheless, currently individual Member States compensate for indirect carbon costs in their own terms with resulting indirect cost compensation practices varying across countries and sectors. This could be improved by:

- **Short to medium term: Maintain but harmonize indirect cost compensation across Member States.** This can be done by amending EU State Aid Guidelines to enforce mandatory minimum thresholds—either by dictating a minimum percentage of national ETS revenues dedicated to ICC, or by establishing an absolute floor for effective aid intensity. This preserves the agility of critical, electro-intensive national value chains while legally mandating cross-border consistency.
- **Long term: Consider the creation of an EU-wide indirect cost compensation system,** conditional on safeguards against the risk that the shift to an EU-wide setup threatens to

lower aid intensity and diminish predictability due to fragmented views among EU policymakers on revenue usage.

3.3. Managing flexibility for the introduction of CDR and international credits

The flexibility enabled by carbon dioxide removals (CDRs) and international credits matters. Some process emissions will require netting with removals to reach the net zero long term goal. Inclusion of CDRs and international credits in the 2030es helps manage the ambitious trajectory cost effectively and it contributes to market liquidity and well-functioning. To this end, we need to *ensure that the volume allowed for use in the ETS is actually met in full* for each category.

CDRs come with new technologies and regulatory challenges. International credits have had their challenges in history. *The introduction of the two categories in the ETS must be managed.*

3.3.1. CDRs

It is far from certain that the 250 million allowances auctioned will translate into 250 Mt of CDR purchases. Ten million additional EUAs proposed for bridging the cost gap to the market price should enable purchasing an initial tranche of the full CDR volume allowed for use in the ETS. Technology costs may be reasonably expected to decrease over time. However, other sources of funding must be arranged to give credibility to achieving in full the program. There is also a lack of clarity in the proposal about the actual number of CDRs the Commission will end up purchasing.

Limitation to two technologies (BioCCS, DACCS) is contested. It excludes biochar carbon removals (BCR), which is not in line with Carbon Removal Certification Framework (CRCF)¹¹, which defines the certification methodologies for DACCS, BioCCS and BCR as permanent carbon removal pathways. See forthcoming ERCST paper on the inclusion of Biochar.

A broader point of principle applies here. The CRCF and the EU ETS are being developed on parallel tracks, and consistency between the two instruments is essential. The CRCF's definitions of permanence, monitoring, verification and liability should serve as the reference standard for ETS eligibility, rather than the ETS developing its own parallel criteria. Defining eligibility by reference to CRCF certification (rather than by enumerating technologies by name) would future-proof the ETS provisions as CRCF methodology develops and avoid the incoherence that currently exists, where the CRCF certifies a technology as a permanent removal while the ETS excludes it.

Fulfilment of the volume allowed in ETS requires a specific governance for coordinating between the ETS purchasing program, other fundings and an environmental certification agency. The Edenhofer proposal¹² identifies three bodies with specific tasks related to CDR:

¹¹ Carbon Removal Certification Framework, EU Regulation 2024/3012

¹² Edenhofer, Ottmar and Franks, Max and Kalkuhl, Matthias and Runge-Metzger, Artur, On the Governance of Carbon Dioxide Removal – a Public Economics Perspective (2023). CESifo Working Paper No. 10370, Available at SSRN: <https://ssrn.com/abstract=4422845>

- European Carbon Central Bank: manages full use of the CDR cap, through reverse auctions, and the environmental liability (permanence, where relevant)
- Green Leap Innovation Authority: supports CDR technologies with appropriate funding, through auctions and subsidies
- Carbon Removal Certification Authority: certifies CDRs, through a scientific assessment

As integrating CDRs into the EU ETS becomes crucial for achieving negative emissions in hard-to-abate sectors, it is important that they are integrated quickly. We believe that integrating them in 2031, as proposed by the Commission, is too late. We could imagine an earlier introduction in 2029, and correspondingly an earlier review assessing the progress with respect to purchasing CDRs in 2032 (instead of 2034).

The proposal of the Commission is to create an additional 250 million EUAs which would be auctioned to provide funds for the purchase of 250 million CDRs which would neutralize the EUAs created, therefore avoiding an increase in the EU ETS budget.

If the amount raised through the sale of the 250 million EUAs would provide insufficient, then there is the provision of taking an additional 10 million EUAs from the Member State auction and use the revenues to buy up the 250 million CDRs.

The fundamental rule should be that the number of CDRs bought cannot be lower than the number of EUAs created to fund the purchase of CDRs.

The current proposal does not have a provision for a scenario where the revenue from the sale of the 250+10 million EUAs is not enough to purchase 250 million CDRs.

One fundamental issue is how the auctioning of EUAs and the purchase of CDRs take place, especially the timing. The following scenarios illustrate how this could play out in practice.

It must be emphasized that in the view of ERCST it is not the role of the regulator to speculate on the EUA vs CDR price, but to provide for all scenarios, even if they may seem to have a low probability. Market behaviour and technology development and cost have proven to defy regulator predictions in the past.

- Scenario 1: CDR are cheaper than EUAs.

Under this scenario, the 250 million EUAs could be auctioned, and 250 Mt of removal units purchased. This would leave surplus auction revenues. The integrity of the cap is preserved.

The policy question is what to do with the excess funds? One option is to put it into the IDB.

- Scenario 2: Insufficient CDR supply

The 250 million EUAs allowances are auctioned and revenues collected, but sufficient removal units cannot be purchased as they are simply not available in the market. The fundamental rule is breached: allowances created but not matched with CDRs. Restoring integrity would require buying back, and cancelling, the unmatched EUAs. This is a scenario for which the current proposals do not provide a remedy for.

- Scenario 3: Allowances partially auctioned

Under this scenario, we create an additional 250 million EUAs, but only 200 million EUAs are auctioned and matched with 200 (or more) CDRs purchased.

The issue is what to do with the remaining 50 million EUAs created but not auctioned? The remaining 50 million EUAs would have to be cancelled.

3.3.2. International credits

Any international credit issued under Article 6.4 of the Paris Agreement must be eligible for purchasing and exchange in one EUA, without further methodological qualification requirements or discount specific to the EU. The EU is a party to the Agreement and deeply involved in establishing the governance and managing the implementation for Article 6.4 operations.

A pilot purchasing programme should commence in 2031 to de-risk the subsequent scale-up and mitigate the risk of failing to fulfil purchasing obligations or fully utilise the volumes permitted under the ETS from 2036, which could otherwise trigger a strengthening of the LRF from 2036.

In a centralised procurement and management model, the role could be housed institutionally in several ways. Funding of the financial resources for the centralised facility needs to be defined whatever form is retained.

- The most integrated option expands the mandate of the MSR revised into a European Carbon Central Bank (see section 3.1) to encompass also the acquisition and management of international credits.
- An alternative rests with a dedicated procurement facility, organised as a joint undertaking or trust fund administered by the Commission in partnership with multilateral development banks.

The review should consider a transition, from 2036 onwards, towards a model whereby compliance entities purchase international credits directly and exchange them for allowances, subject to a defined limit. Such a limit could be determined on the basis of annual emissions or the level of free allocation.

3.4. A governance framework for enabling the transition

As already stated in ERCST's reflection note on the proposal, many ingredients are present in the proposal, but the glue that holds all the elements together is missing. This glue is a solid governance framework for the EU ETS, one that can manage - in the medium to long term - deviations or changes from KPIs linked to the external conditions not under the control of the installations, that are necessary condition for decarbonization of the ETS covered sectors. This governance function should thus operate across two dimensions: managing external conditionality and managing the system's main tools. The availability of such governance would eliminate the need for periodic reviews that result in step changes of EU ETS regulations.

Managing external conditions

Decarbonization is not only a function of action by covered entities based on an EU ETS price signal, but also depends on factors outside their control, which vary by region and sector. We have identified several external conditions that the governance body should track, and they will include:

1. The existence of a market for low-carbon products. Low-carbon steel, cement, chemicals, aluminium etc are currently more expensive, so there is no business case for them yet.
2. An increasing rate of electrification. In this regard, the Electrification Action Plan published on the same date as the ETS proposal will probably help achieve this.
3. The availability of low carbon electricity, hydrogen, and other sustainable fuels at competitive prices.
4. The availability of infrastructures enabling alternative low carbon production and use (e.g electricity grid distribution, hydrogen production and transportation, CO₂ transport and storage capacity)

Managing the system's (decarbonization) tools

The governance body would manage the following aspects and tools:

1. The carbon price. The governance body will need to perform a market oversight function, ensuring sufficient liquidity in the system on the one hand, and controlling volatility on the other. This has become crucial as we move from a situation of surplus of allowances to one of scarcity.
2. The carbon costs. This involves monitor a set of agreed external condition KPIs and introducing flexibility safeguards for addressing costs if KPIs are missed. When the KPIs are met, free allocation and funding would follow normal protocol. However, in case there are not met, flexibility is needed on free allocation, the funding or the changes in compliance obligations.
3. CDRs. Two elements need attention here. First, the governance body should manage removal procurement - potentially through reverse auctions. Second, it must also address the question of liability.¹³ This solution would solve a serious caveat in the proposal. Indeed, it is assumed that the 250 Mt of removals will happen, but the conditions for that to happen are by no means guaranteed.
4. Ensure rigorous oversight of financing architecture (revenue recycling, IDB, etc):
 - Establish a transparent, robust governance framework to oversee the newly Industrial Decarbonization Bank (IDB) and its initial Investment Booster phase.

¹³ ¹³ Edenhofer, Ottmar and Franks, Max and Kalkuhl, Matthias and Runge-Metzger, Artur, On the Governance of Carbon Dioxide Removal – a Public Economics Perspective (2023). CESifo Working Paper No. 10370, Available at SSRN: <https://ssrn.com/abstract=4422845> or <http://dx.doi.org/10.2139/ssrn.4422845>

- Regulatory oversight must ensure that the recycling of EU ETS auction revenues—specifically the mandated % earmarked for EU ETS sectors—is directly returned to the exposed industries bearing the carbon costs, rather than diluted across broader national budgets.
- Supervise other EU-level instruments such as an indirect cost compensation scheme at the EU level.

Regarding international credits, since they are not directly used by entities for compliance under the EU ETS, it is not strictly necessary to manage their introduction under the same governance umbrella - though it could still prove useful.

Governance over emissions from international aviation and maritime should remain under ICAO and IMO respectively, as per the UNFCCC mandate.

There are several ways this new governance could be embodied. A first option would be to make the existing MSR more flexible. As explained in Section 3.1, the release rate and intake rate could become dynamic, and Article 29a could be modified to react better to short-term volatility. Another option would be to set up an independent European Carbon Central Bank (ECCB) looking at market oversight. The rationale for creating this new entity builds on the idea that carbon allowances are very similar to currencies and that they should therefore be managed in a similar way. Although conceptually attractive, this second option is more politically and procedurally demanding.

There appears to be a political will to move quickly on reforming the EU ETS, with the aim of delivering an outcome by the end of Q1 2027 - just before the French elections. A broader reflection on governance does not seem to be an immediate priority, which leaves the door open to multiple one-off revisions. This ultimately undermines the stability of the system, a stability that is a necessary condition for a successful transition. If governance is not going to be addressed in this review of the EU ETS, then at the very least a work programme on governance should be established. Concretely, the European Commission should be mandated to bring forward a proposal on a governance framework for the EU ETS 12 months after consensus is reached.

4. Annex: Managing the EU ETS as a decarbonization tool

This Annex is organized along the following logic:

1. Set the principles for the discussion and show that managing the EU ETS for decarbonization is necessary.
2. Identify what is currently managed in the EU ETS
3. Explain why the current EU ETS regime is not fit-for-purpose anymore
4. Identify what needs to be managed for the EU ETS to be able to play its role in the decarbonization journey.

4.1. Managing principles of the EU ETS as a decarbonization tool

- The EU ETS carbon market is not a natural market, but a regulatory one, with a regulatory-determined scarcity. In setting the scarcity, several factors need to be considered, informed by atmospheric science.
- While the EU ETS and the carbon price signal are central elements of EU climate policy, they are but one element that must come together with others to create a sustainable decarbonization and transition.
- This calls for the **need to manage the EU ETS** and its relationship with other conditions necessary for decarbonization. Therefore, the EU ETS **is required to**:
 - Be a well-functioning market with good price discovery - one that provides a signal for decarbonization and an incentive for clean investment (the price of EUA and the cost of compliance).
 - Provide a signal that contributes to a sustainable transition – ensuring that the economic/competitive and social axes are moving at the same speed.
 - The speed (signalled through EUA price/cost) cannot be decoupled from surrounding conditions and needs to be managed.
- At ERCST, we concluded that meeting these requirements translates into managing several elements:
 1. **Price & good market functioning.** This means good price discovery, as well as a EUA price level and robustness that provides an incentive not only not to do certain things, but what is more important, for investment in clean technologies.
 2. **Costs of compliance**, which impacts competitiveness.
 3. **Flexibility for the introduction of CDR** for net zero and international credits.
 4. **Enabling the transition**, including:
 - **Articulation with external conditions**, i.e., that the EU ETS price signal can trigger change, that the conditions exist to act, such as existing rate of electrification, availability of low-carbon electricity, hydrogen, CCS, market for low-carbon products, etc.
 - **Funding (incl. revenue recycling)**
 5. **Governance**

4.2. How the EU ETS is being managed now

The EU ETS has focused on managing the EUA price trajectory as there were concerns about the role of the EU ETS in decarbonization, given the price trajectory in Phase 2 and early Phase 3 (the price level was not enough to signal investments in decarbonization). Cost was less of a concern due to EUA price levels and the availability of free allocation.

Price trajectory

- The MSR is the primary management tool of the EU ETS today and was introduced to manage the supply/demand balance and, through it, the EUA price trajectory.
- There was an evolution and change in the role of the MSR, which also played the role of a surrogate/primitive Carbon Bank as more features were added over time:
 - Modifying the cap through the introduction of the invalidation provision.
 - Releasing volumes to feed different financial streams such as the RePower EU and the Innovation Fund and to cater for new entrants' free allocations in phase 4.

Volatility

- Art 29a was intended to manage price volatility but was never triggered. Price trajectory and price volatility are two different concepts that should not be confused. The MSR manages the price trajectory, while the objective of Art 29a is to manage volatility, should it occur.

Cost of compliance

- The cost of compliance was largely managed through the provision of Free Allocation and Indirect Cost Compensation (ICC).

4.3. Changing circumstances in which EU ETS functions

ERCST has examined in depth¹⁴ the issue of changing circumstances under which the EU ETS functions and the transition takes place, in general. The issues below merit highlighting for the purpose of this discussion:

- Generalized EU ETS shortages annual shortage in the second half of 2020s and TNAC continuing to decrease to or below MSR upper threshold 0.8 bn EUAs. EUA prices are expected to enter new territory.
- As a result of the phase-out of free allocation, due to the introduction of CBAM, the hedging needs of industry are structurally transformed and rising.
- We are moving from the decarbonization of the power sector to decarbonization of heavy industry, in the context of increasing industry competitive pressures, due to decrease in carbon leakage protection, moving up the marginal abatement cost (MAC) curve, increased energy prices, trade measures, and over-regulation.

¹⁴ See Marcu, A., (2026), EU ETS Review: Issues and Levers, ERCST, April 2026 <https://ercst.org/eu-ets-review-issues-and-levers/>

- Available public financial resources are more limited
- Upcoming concerns about liquidity in the EU ETS in the mid-to-late 2030s. While liquidity is not yet a problem today, with the current LRF and from the perspective of the trading community, it is likely to become a problem in the mid-2030s resulting in price volatility and not good market functioning.

4.4. Post 2026 ETS management: what, how and who

4.4.1. EU ETS stability

The EU ETS is an instrument that has been adjusted over the years, and, as a regulatory market, its credibility rests largely on the confidence that stakeholders, especially market players, have in its stability and longevity. Since the EU ETS is central to EU climate policy, any changes that are contemplated must ensure that confidence in the EU ETS is maintained. Therefore, while changes are necessary, their implementation must be informed by the timeline that is required for their implementation in order not to destabilize the EU ETS. Some changes:

- Can be implemented in the short term and will not depart significantly from the existing architecture that is well-known, tested, and trusted. Changes in the MSR parameters are an example of such changes.
- Require significant modifications in architecture and, possibly more important, on governance. Some would call these changes political, but we believe that is not totally true, as everything related to climate change policy and EU ETS has a political undertone. These changes will require a longer time to develop, implement, and gain confidence with market actors.

4.4.2. EU ETS elements to be managed

Until now, the main preoccupation for those regulating and acting in the EU ETS has been to manage prices to ensure a price signal that triggered decarbonization action. Cost management was achieved through free allocation and Indirect Cost Compensation (ICC). Given the new circumstances outlined in Section 4.3 above, additional elements need to be managed, which is more complex.

1. Well-functioning market and price

We continue to need to ensure that we have a well-functioning market, and this can be achieved through measures that can be put in place in the short-term, since

- They do not depart from what is known and trusted and
- Do not change the architecture or governance of the EU ETS.

Price trajectory

The MSR is the key lever for a good market functioning, and will have to be adapted to the current realities

1. Thresholds will need to be adjusted to meet new hedging needs

2. Absorption and release rates were put in place for when the market was long and need to recognize the current switch to market shortages.
3. The cancellation provision is already being considered for removal. Cancellation leads to a back-door change in the EU ETS budget, which was never the purpose of the MSR. Returning EUAs in the MSR to the market will not change the EU ETS budget, and neither will revalidating invalidated EUAs impact the environmental aspects of the EU ETS.
4. Dynamic MSR. Proposals have been put forward for a dynamic MSR, one that does not function in quantum steps but is more attuned to market function and is another step to a more flexible governance. This should be given serious consideration¹⁵.

Price volatility

Art 29a was never triggered but, as volatility is expected to increase with market surplus no longer acting as buffer, and with market size shrinking over time alongside the cap, reviewing its parameters must be part of the EU ETS review. From ERCST's point of view this mechanism should be about price volatility and as such it should be a two-way mechanism. However, it has become obvious that the intent and support seems to be primarily to address the upside volatility as a priority.

II. Managing costs/competitiveness

Competition has become central to the reality of the EU, mired in an industrial crisis, with free allocation being phased out in several sectors, with other sectors to follow in 2028. New ways of addressing competitiveness concerns need to be put in place.

Managing costs includes both mitigating the running compliance costs for trade-exposed sectors and supporting the investment and running costs of decarbonized solutions

Free Allocation

Co-existence of CBAM and free allocation. It has been an article of faith that free allocation and CBAM act the same way, and their co-existence would be double protection and break WTO rules.

The study undertaken by ERCST and CEC casts some doubt on that truism¹⁶ as it concludes that:

- CBAM and free allocation should be seen more as complements rather than substitutes in addressing carbon leakage over the long run, as they operate through different economic channels:
 - CBAM primarily affects relative prices and trading conditions. CBAM affects marginal unit pricing and, therefore, the marginal competitiveness of imports.

¹⁵ See <https://veyt.com/wp-content/uploads/2025/10/EU-ETS-Market-Stability-Reserve-review-Flexibility-is-the-magic-word-4.pdf>

¹⁶ See ERCST (2026), Carbon Leakage under CBAM and Free Allocation <https://ercst.org/carbon-leakage-under-cbam-and-free-allocation/>

- Free allocation, by contrast, primarily affects firms' profitability and balance sheet constraints.
- CBAM is an important tool to protect EU industry from carbon leakage. It helps ensure that imports face a carbon cost when they enter the EU market. This supports EU production and can encourage cleaner production both in Europe and abroad.
- However, CBAM does not fully address the risk of carbon leakage. It protects the EU market from imports. It does not protect exports, complex value chains or downstream sectors.
- This is why free allocation remains important during the transition. Free allowances help companies manage carbon costs, maintain profitability and keep investing in decarbonisation. Without enough free allocation, even efficient low-carbon EU producers may face rising costs that weaken their competitiveness.
- Combining CBAM with a reasonable level of free allocation can deliver the best results. It can support cleaner EU production, reduce import dependence, and limit negative effects on downstream sectors. The CBAM Regulation establishes the coexistence of CBAM and free allocation under Article 31.
- Some level of free allocation can be maintained in the presence of CBAM, and extending the free allocation phase-out, such as through backloading CBAM, is certainly an option that cannot be discarded without examination. Separately, a fair level playing for exports of sectors under CBAM can also be achieved through free allocations.
- The conditionality clause for accessing free allocation is questionable, but should that be considered it has to be coupled with the conditionality for external conditions, or else it is an asymmetrical approach.
- There is an argument that the cross-sectoral correction factor (CSCF) would be triggered eventually unless additional free allocation can be found. The additional free allocation can be provided through:
 - A lower LRF that will ensure further additional free allocation. Changes to the LRF, such as proposals from the European Parliament for an even lower LRF than the EC proposal should be considered;
 - Rebalancing free allocation and auctioning percentages;
 - By bringing existing or revalidated EUAs from the MSR in the form of free allocation.

Benchmarks

- Benchmarks are currently under discussion, with relief being considered

Auctioning money for industry decarbonization

- The auction revenue must be better directed towards industrial decarbonization but will always be a second best to free allocation.
- Additional resources can be made available by accessing the EUAs in the MSR, or invalidated
- Use of EU ETS revenues should expand beyond providing capital expenditure (CAPEX) support to offer robust operational expenditure (OPEX) support. To encourage electrification of industry, consideration should be given to earmarking EU ETS revenues to industrial OPEX support and de-risking tools to mitigate the risk of volatile power prices.

Indirect Cost Compensation

- Maintaining ICC is as critical as free allocation for current circumstances, and even more so for an increasing rate of industrial electrification, while the marginal pricing model in the electricity market is in force.
- ICC is currently decided at the Member State level. The review should include consideration of raising it at the EU or establishing horizontal requirements for minimum aid intensity for consistency and coherence.

III. Managing flexibility for the introduction of CDR and international credits

Managing flexibility provisions

- Since there are clearly process emissions that will need to be addressed to reach net zero, the introduction of CDR cannot be put in question.
- To launch the technology and debug any regulatory challenges, the introduction of CDRs needs to be managed.
- Similarly, flexibility to reach the EU ETS cap may be needed as we move up the MAC curve on a very ambitious timetable.
- International credits may provide that flexibility, but given the history of the use of international credits in the EU climate change framework, the introduction of international credits in the EU ETS will also need to be managed.

IV. Enabling the transition

Funding the transition

- Funding the transition requires a strategic mix of capital investment (Capex) and operational subsidies (Opex) to bridge the cost gap with fossil fuels.
- Governments and development banks leverage recycling carbon pricing revenues alongside targeted derisking tools (CCfDs).

Need to manage articulation with external conditions

- The EU ETS was put in place to drive the decarbonization and not to create a new market. As such, the price signal must be articulated with the external conditions that need to be in place to ensure that the installations can implement concrete measures.
- It must be emphasized that this “conditionality”, which, in simple words, means taking into account whether there is enough renewable energy in the right places, whether the infrastructure for electrification is available (e.g., an electricity grid) or if there is hydrogen and CCS available, is not a nice-to-have condition, but a logical and necessary one.
- If the mechanism to ensure this articulation is not put in place, then the probable outcome will be a series of one-off regulatory interventions in the EU ETS, while businesses generally see regulatory stability and predictability as a necessary condition for investment.

V. Governance

- Managing external conditionalities, in addition to managing price and cost, is complex, and it is unlikely that it can be done through mathematical formulas, which is the current governance for managing prices through the MSR – it will require a different governance.
- Since the creation of new institutions, such as a Carbon Bank, is a long-drawn process, the most likely candidate that would cause the least disruption and is known to market players would be an enhanced MSR, with new functions and flexible governance. Putting in place such new governance abruptly poses risks to market confidence, faced with yet another new and untested instrument in addition to the CBAM
- It must be emphasized that the MSR was already called to play several roles in the past, so this should not be seen as something totally new.
- This is a more complex change and needs significant work and lead time to implement – but needs to be started now to be implementable in a useful time.
- A special instrument with flexible governance will likely be required for managing CDRs, and international credits at least in the pilot phase envisaged in the climate law.
- The availability of an instrument that can manage its introduction, with the flexibility of a governance described above, is something that needs to be part of the review. An adapted MSR in terms of governance and functions is, as was described above, probably a good candidate to be considered.