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ERCST Report

EU ETS Review: Free Allocation Investment Conditionality

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EXECUTIVE SUMMARY

The European Commission's 2026 EU ETS review proposal introduces a significant change to the role of free allocation by making part of it conditional on decarbonisation investment. Under the proposal, 80% of eligible free allocation would be linked to the submission of an approved *Invest in the EU Decarbonisation Plan*, while the remaining 20% would depend on implementation of investments in the EU corresponding to the economic value of the full free allocation received.

The objective of accelerating industrial decarbonisation and anchoring investment in Europe is important. However, the proposed conditionality does not address the underlying factors determining whether such investments are technically ready, operationally feasible and economically viable, including access to infrastructure, low-carbon energy and technologies at competitive costs.

Investment conditionality is not entirely new. Positive investment conditionalities that incentivize compliance by offering rewards (i.e. additional free allocation or support) already exist within the EU ETS and State aid frameworks. However, the proposed approach goes significantly further by linking existing benchmark-based free allocation—and therefore carbon-leakage protection—to an investment obligation. This risks giving free allocation two potentially competing objectives: protecting against carbon leakage and directing corporate decarbonisation investment.

The proposal also raises competitiveness and carbon-market concerns. Withholding 20% of free allocation creates additional costs and short-term allowance scarcity, affecting hedging behaviour and price volatility and interacting with the MSR. Important uncertainties also remain regarding qualifying investments, CAPEX and OPEX, exemptions and the relocation clawback.

The preferred approach would be to strengthen the business case for industrial decarbonisation through supportive instruments, including CCfDs, direct investment support and demand-side policies for low-carbon products.

If free-allocation conditionality is nevertheless retained, obligations should first be conditional on the availability of technically ready and feasible solutions as well as the infrastructure and competitively priced low-carbon energy required to implement them.

The report proposes two alternative pathways. *Pathway A – Positive Conditionality* would preserve 100% of benchmark-based free allocation and provide additional free allocation to installations that voluntarily undertake and deliver verified decarbonisation commitments. *Pathway B – Simplified and Flexible Investment Conditionality* would allow operators to demonstrate compliance primarily through verified eligible decarbonisation expenditure and existing financial reporting and certification mechanisms, rather than detailed installation-level investment plans. Both approaches seek to incentivise investment while limiting administrative burden and preserving the carbon-leakage protection function of free allocation.

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1. Introduction & Context

The European Commission's proposal for the EU ETS Review, published in July 2026, introduced significant changes to the free allocation rules for phase V by putting forward the concept of investment conditionality for free allocation. In simple terms, 80% of the eligible free allocation is made conditional on the submission of an Invest in the EU Decarbonisation Plan, which has to be approved at Member State level. The remaining 20% is allocated no later than two years after the end of the relevant five-year period, on two conditions: the investments have been implemented in the EU, and the invested amounts are at least equal to the economic value of 100% of the free allocation received over the five-year period. These investments can be pooled at corporate level rather than demonstrated installation by installation. The proposal also provides for a relocation clawback: if an installation relocates, it would need to give back the free allocation received for the allocation period. A few installations are exempted from this conditionality: the 10% best performers, zero-emission or low-carbon installations, and installations that voluntarily remain in the scope of the EU ETS.

The objective of this report is twofold. First, it presents ERCST's view on the investment conditionality as set out in the proposal. It covers conceptual considerations, the consequences for competitiveness and the carbon market, as well as the uncertainties raised by the proposal. Second it puts forward the need for double conditionality and two alternative pathways to the one proposed by the European Commission: a positive conditionality pathway that incentivizes investment that offers additional free allocation as a reward, as well as a simplified and flexible demonstration of decarbonisation investments pathway.

2. Objectives and Challenges of Investment Conditionality

2.1. Stated Objective of Conditional Free Allocation

The primary goal of the free allocation investment conditionality provision, as stated in the proposal's explanatory memorandum, is to strengthen incentives to invest in decarbonisation measures and anchor low-carbon industrial investments within the Union.

It is important to stress that the core policy objective of keeping industrial investment inside the EU, and accelerating decarbonisation, are desirable and a necessary condition for future EU prosperity. The proposed provision, however, would also apply to free allocation for district heating, a sector that is not on the carbon leakage list under Delegated Decision (EU) 2019/708 and whose installations cannot be relocated outside the EU. If the purpose of conditionality is to keep investment in Europe, this logic does not apply to district heating.

What is needed is to ensure that there is a business case for decarbonisation investments in the EU and closing the investment gap, which we believe the conditionality investment clause will not address.

2.2. Existing conditionalities

Investment conditionality is not entirely new: positive investment conditionalities that incentivizes compliance by offering rewards (i.e. additional free allocation or support) when certain criteria are met already exist in the EU ETS and State aid frameworks.

However, applying broadly negative investment conditionality that punishes non-compliance by imposing sanctions (i.e. losing free allocation) when criteria are not met represents a new approach.

Moreover, under State aid frameworks, investment is typically one of several available compliance routes, and compliance with investment-related requirements can primarily be demonstrated through verified eligible decarbonisation expenditure.

2.2.1. Existing conditionalities for EU ETS free allocation

The 2023 ETS revision (Directive 2023/959, Fit for 55), introduced three types of conditionalities for the second half of Phase 4 of the EU ETS. Free allocation is no longer automatic as operators must meet conditions to receive their full allowances.

1. **Energy Efficiency**: requires operators to fully implement EE recommendations from energy audits performed in the context of EED whose payback period falls below a specific threshold, or face a 20% cut in their free allowances (negative conditionality);
2. **Worst performers**: Worst 20% emitters per benchmark required to develop/submit and implement verified Climate Neutrality Plans (CNP) or face a 20% cut in their free allowances (negative conditionality).
3. **District heating (DH) investment conditionality:** eligible DH operators in 4 MSs (Bulgaria, Czech Republic, Latvia, Poland) can receive additional free allocation of 30% provided they invest equivalent amount in decarbonisation before 2030 in accordance with climate-neutrality plans (positive conditionality).

The conditionalities currently attached to free allocation under the EU ETS therefore require operators to invest, but the required investment is not linked to the value of the free allocation they receive. Moreover, the first two conditionalities each cover only a narrow subset of installations rather than all recipients of free allocation.

2.2.2. Decarbonization or investment conditionalities outside the EU ETS

Some form of *decarbonization* or *investment* conditionality can also be found outside the core EU ETS framework, particularly in State aid instruments. As these mechanisms establish conditions that beneficiaries must fulfil to receive support, they can broadly be characterised as positive conditionalities. Importantly, investment is often one of several available compliance routes, rather than the sole means of satisfying the conditionality.

1. Clean Industrial Deal State Aid Framework (CISAF)

Under Section 4.5 of CISAF, Member States may provide temporary electricity-price relief to eligible energy-intensive industries exposed to international competition. The support is explicitly linked to a decarbonisation investment obligation for beneficiaries.

Specifically, beneficiaries must allocate at least 50% of the aid amount to investments in new or modernised assets that can demonstrably make an additional contribution to reducing electricity-system costs, without increasing fossil-fuel consumption. Eligible investments can include:

- Renewable electricity generation;
- Energy storage;
- Demand-side flexibility;
- Energy-efficiency improvements affecting electricity demand;
- Renewable or low-carbon hydrogen electrolysers; and
- Electrification investments.

CISAF provides an existing precedent for an expenditure-based approach to investment conditionality: the beneficiary must allocate a defined proportion of the economic support received (at least 50% of the aid amount) to qualifying investments. That differs conceptually from requiring each ETS installation to develop a detailed installation-specific investment plan and linking part of its free allocation to implementation of that plan.

There is also an important difference in the scale of the financial obligation: Under CISAF, at least 50% of the aid received must be allocated to qualifying investments, whereas the Commission's 2026 EU ETS reform proposal links the investment obligation to the total economic value of free allocation over the relevant period.

2. Temporary Decarbonisation Fund (TDF)

Under the proposed[1] TDF, support granted by the Fund would be conditional on the beneficiary demonstrating decarbonisation efforts 2.

Rather than a pure investment conditionality, the proposed TDF contains a *decarbonisation* conditionality but with an investment component: operators may satisfy the conditionality through a legally binding commitment to decarbonisation investments linked to their climate-neutrality plan, with the investment amount at least equivalent to the TDF support applied for. However, investment is not the only compliance route, as Article 7 also recognises implementation of energy-audit recommendations and certain circumstances in which remaining recommended investments have a payback period exceeding five years.

The TDF therefore illustrates a more flexible approach in which investment constitutes one possible means of demonstrating decarbonisation efforts.

[1] COM/2025/990 final. The TDF is a file that remains in the legislative process, not final law, with the European Parliament having adopted amendments in September 2026.
[2] COM/2025/990 final

3. EU ETS indirect cost compensation

Under Article 10a(6) of the ETS Directive, Member States may compensate electricity-intensive sectors for indirect carbon costs passed through electricity prices. The State aid rules governing EU ETS indirect cost compensation3 also contain decarbonisation and investment conditionalities.

For beneficiaries subject to the relevant energy-audit obligation, compliance can be demonstrated through one of four alternative routes:

Route	Conditionality
1. Energy-efficiency investments	Implement recommendations from the energy audit where the payback period does not exceed 3 years and the investment cost is proportionate
2. Carbon-free electricity	Reduce the carbon footprint of electricity consumption so that at least 30% of electricity consumption comes from carbon-free sources.
3. Decarbonisation investment	**Invest** at least 50% of the aid amount in projects leading to substantial reductions in the installation's GHG emissions.
4. Electricity system cost-reduction investment (added by the 2026 amendment)	**Invest at least 50% of the aid amount** in new or modernised assets that measurably reduce electricity system costs, without increasing fossil fuel use (e.g. renewables, storage, demand-side flexibility, electrolysers, electrification). Demand-side flexibility must always be eligible.

As under the proposed TDF, investment is therefore one of several alternative compliance routes rather than the sole condition for receiving support.

Taken together, these State aid instruments demonstrate that (positive) investment conditionality is not in itself a novel concept. They also illustrate alternative approaches to its design: investment obligations may be linked to a defined proportion of the support received; investment may constitute one of several alternative routes for demonstrating decarbonisation efforts; and compliance with investment-related requirements may be demonstrated primarily through an expenditure-based approach.

2.3. Conceptual Considerations

The proposal represents a significant change from the precedent set as described above, and in its current form it crosses what we would regard as lines that should not be crossed. There is a paradigm shift. As explained in the previous section, conditionality in itself is not entirely new. In this case, however, it changes the nature of the instrument, and the term “free allocation” becomes a misnomer.

[3] The detailed rules are contained in the Commission's EU ETS State Aid Guidelines post-2021 (2020/C 317/04), as well as the 2026 amendments (Communication from the Commission amending the Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post-2021, OJ C/2026/196)

Free allocation is no longer free: 20% of it now comes at the cost of investing in decarbonisation measures. Until now, the availability of free allocation was not seen as a lever for decarbonisation; the incentive to decarbonise came from the benchmarks. Adding conditionality turns free allocation itself into such a lever, which is a significant departure from the regulatory ethos in place since the start of the EU ETS. This is particularly problematic for industry, which is significantly exposed to international trade.

Free allocation has always been presented as a way to address carbon leakage and to level the playing field domestically. Under this proposal, only 80% of it addresses carbon leakage, which reduces carbon leakage protection. Free allocation would then serve two purposes as an economic instrument: preventing carbon leakage and incentivising decarbonisation. Giving an economic instrument more than one objective does not usually produce an efficient and effective outcome.

Conditionality represents a quantum leap in the nature of the intervention, as public authorities would intrude far more heavily into corporate governance and take on a decision-making role in how companies are run. These broader objections rest on fiduciary responsibility and on general principles of state intervention in the functioning of a free market. The existence of previous examples does not necessarily make it right.

The acceptability of this mechanism hinges on several issues:

- If an investment is fundamentally uneconomical (unprofitable) due to (external) structural factors, i.e. there is no business case for the investment (capital and/or operations), using conditionality as a lever to force it is not a sustainable approach.
- There are two avenues:
    - The conditionality to invest even if the investment is not profitable. Mandatory compliance frameworks should not force capital and/or operations into projects that yield sub-optimal or negative financial returns compared to alternative business investments which such a concept not viable, not sustainable and not aligned with a free market economy.
    - The conditionality is set to only invest in profitable projects. This concept is not a viable on as it would require operators to prove that the project is uneconomical. Shifting the bureaucratic burden onto operators to prove a project's unfeasibility creates an unnecessary operational hurdle.
- Even if decarbonization investments make economic sense, navigating the formal verification and approval process of decarbonisation plans introduces a hurdle and therefore regulatory, operational, and execution risks for a corporation.

The decarbonisation project must also be technically feasible. For several production processes covered by the EU ETS, no technology currently exists that would allow the installation to decarbonise, as technical and chemical constraints prevent further emission reductions. Making free allocation conditional will not accelerate technological development for these installations; it will only make them less competitive on the global market.

Finally, CBAM is meant to address the risk of carbon leakage resulting from the EU ETS carbon price, and its provisions should mirror those of the EU ETS. Free allocation conditionality cannot effectively be mirrored in CBAM, which provides a further argument that this provision is not viable. European installations would face additional investment and compliance requirements on top of existing ETS monitoring, reporting and verification obligations and risk losing free allocation for non-compliance. Meanwhile, third-country producers would retain the corresponding reduction in the CBAM charge without equivalent conditionalities, disadvantaging European producers against the very imports CBAM is intended to address.

2.4. Consequences

As it currently stands, the investment conditionality clause would have a clear impact both on the competitiveness of covered installations and on the functioning of the market.

Regarding competitiveness, the clause relies on a mechanism that conflates existing operational viability with forward-looking capital deployment. By delaying the release of the remaining 20% of free allocation until sometime after verification, it lowers the net present value (NPV) of investments. In addition, it introduces complex verification layers, creating significant red tape for both operators and Member State competent authorities.

Regarding the functioning of the market, the conditionality raises two main concerns:

First, it affects market liquidity and price volatility. Limiting the free allocation initially available to 80% creates a backloading effect and structural price volatility. In the first years, until the remaining 20% is released, the market would face new annual scarcity. Companies may also hedge the 20% annual shortfall over several years, causing a demand peak in the first year(s). This could lead to a price spike in the early years of implementation, followed by downward pressure on prices once the retained free allocation finally enters the market.

Second, the delayed release of free allocation would interact with the Market Stability Reserve (MSR) through its impact on the total number of allowances in circulation (TNAC). The TNAC could initially be pushed below the lower threshold, triggering releases from the MSR, before jumping above the upper threshold once the 20% is released, leading to intakes into the MSR. This would fundamentally change the way the market is managed.

2.5. Uncertainties

Several provisions on the proposed investment conditionality are not sufficiently clear and leave several questions open. Greater clarity on these points is important for having an informed debate but do not change the fundamental conclusion of the desirability and viability of this provision, as they have important consequences for the installations concerned.

- **Invest in EU decarbonisation plans**: Clarity is needed on the plan that installations must submit, as the proposal does not specify what the plan should contain. Moreover, since plans will be approved at national level by the competent authority, there is a risk of unequal treatment among Member States. More generally, the new framework should avoid creating additional or overlapping planning obligations; rather it should be aligned with and build on existing requirements such as climate neutrality plans or transformation plans prepared by district heating companies pursuant to Article 26(5) of the Energy Efficiency Directive (EED).
- **Defining Investment and Qualifying Expenditures:** The proposed regulation refers to "investment", which seems to indicate that it targets capital expenditure (CAPEX). However, CAPEX support is a necessary but not sufficient condition. Indeed, low-carbon production often costs more to operate, for example due to electricity costs for electrified processes or the cost of hydrogen or biomass as feedstock. Operational expenditure (OPEX) would thus have to be taken into consideration as well. While Recital (46) refers to both CAPEX and OPEX, Article 10a does not. Article 10a should therefore be amended to remove this discrepancy and clearly define how capital CAPEX and OPEX combine to equal 100% of the financial value of the free allocation.
- **Exemptions**: The proposal exempts three types of installations from conditionality: the 10% best performers, installations that voluntarily remain in the scope of the EU ETS, and installations that qualify as zero-emission or low-carbon. The last category deserves more clarity. The definition is not clearly set out and is currently very broad, since the proposal only states that the Commission shall "take into account the sector specific emissions reductions that are necessary by 2040 and 2050 to be in line with the climate neutrality objective". Visibility on which installations are covered by conditionality, and which are not is important. In this regard, the delegated act to be adopted by the Commission will need to be followed closely. Moreover, operators may not know whether they qualify for an exemption by the deadline for submitting their *Invest in EU decarbonisation plans* (proposed as 30 September 2029 for existing installations). Eligibility for the best-performer exemption will depend on the benchmark values applicable for 2031–2035, which are not expected to be published until around 2030. This creates a timing mismatch whereby operators may be required to prepare and submit investment plans before knowing whether they are subject to the requirement.
- **The 10% best-performer exemption could create a regulatory cliff effect**. In industries where installations use broadly the same technology, differences in emissions performance between the best-performing 10% and the remaining installations can be very small. Minor operational changes or temporary disruptions can alter their relative performance from one year to the next, without reflecting meaningful differences in technology or decarbonisation progress. Subjecting installations with very similar emissions performance to substantially different conditionality requirements and levels of carbon leakage protection could therefore produce disproportionate and potentially inequitable outcomes.
- **Relocation clawback clause**: The relocation clawback clause leaves it unclear what can be clawed back and under which circumstances. The clause applies to allowances received "in accordance with the first subparagraph", but where the operator does not reimburse them, the Member State must deduct free allowances in the following years, which could in practice affect the 80% share as well. The wording also relies on a very broad definition of relocation, covering any installation that has "relocated or otherwise, directly or indirectly, transferred, in

whole or in part, its relevant production capacity or the associated economic activity outside the Union". Thus, in practice, an EU installation shifting part of its output to a plant in a third country could see its free allocation withdrawn. This is problematic, as such shifts may reflect commercial decisions rather than actual carbon leakage.

3. Alternative Policy Approaches & Operationalizing the Framework

The proposed approach raises fundamental concerns regarding both its conceptual basis and its operational viability. As set out above, it would also have a negative impact on the functioning of the market and on the competitiveness of EU industry. This section therefore sets out alternative incentives and conditionality pathways to those in the current proposal.

3.1. Alternative Incentives

The investment gap should be addressed instead through non-punitive, supportive policy instruments to stimulate low-carbon deployment without risking industrial flight. These can encompass:

- **Funding-type policies**, such asset-linked Carbon Contracts for Difference (CCfDs), or direct co-investment grants from the Industrial Decarbonisation Bank (IDB).
- **Policies creating demand for low carbon products**: with funding de facto limited in "power' by the fiscal realities of the EU and its Member States, incentives at the required scale will need to also come from policies that create demand-side market value for low carbon products.

3.2. Alternatives Pathways to Current Free Allocation Conditionality Proposal

Should the concept of investment conditionality be retained in the negotiations with the European Parliament and the Council, we consider that it should recognise external conditionalities – i.e. factors outside the control of operators (see 3.2.1), and could follow one of two alternative design pathways (see 3.2.2 and 3.2.3).

3.2.1. The Prerequisite: double conditionality

If the principle of conditionality is accepted and enshrined in the EU ETS, it follows logically that it should also apply the other way around: the obligations on operators should in turn depend on certain conditions being met. The most obvious condition is to align compliance obligations with factors outside the operator's control. In practice, targets and compliance obligations would need to be tied to the local availability of hydrogen networks, clean electricity infrastructure and Carbon

Capture, Utilisation and Storage (CCUS) networks, as well as to the availability of low-carbon energy and energy carriers at competitive prices.

Alternative approaches that include a free allocation conditionality clause are presented below. A caveat for all alternatives is that the decarbonization project must be technically feasible, meaning that the technology to decarbonize the process must be available for implementation.

3.2.2. Pathway A: Positive Conditionality

The first alternative is a "positive conditionality", building on the precedent set by the district heating investment conditionality (see section 2.2). It would have the following features:

- **100% baseline free allocation** (i.e. 100% of the benchmark), to mitigate the risk of carbon leakage.
- **An additional "bonus" layer of free allowances**, rewarding installations that voluntarily choose to submit a verified plan and successfully deliver verified decarbonisation milestones.

Given that the Cross-Sectoral Correction Factor (CSCF) is expected to be triggered as of 2031 and would apply in most years of Phase V[4], bonus free allocations should be sourced either from the auctioning share or other available sources (MSR, invalidated EUAs), rather than from the existing free-allocation envelope. Financing the bonus externally to the free-allocation envelope means that better-performing installations receive an actual additional incentive, rather than simply redistributing an increasingly scarce pool of free allowances among installations.

Option B below departs from some of the arguments set out in section 2.3 (Conceptual considerations); nevertheless, we put it forward in the interest of providing a more comprehensive range of policy options for consideration.

3.2.3. Pathway B: Simplified and flexible demonstration of decarbonisation investments

The second alternative pathway entails a simplified and flexible approach to demonstrating decarbonisation investments. To reduce administrative complexity and compliance costs, investment conditionality for free allocation could be based on a technology-neutral framework under which compliance is demonstrated primarily through verified eligible decarbonisation expenditure, drawing where appropriate on existing financial reporting, investment commitments and recognised third-party certification mechanisms. This would avoid the need for detailed regulatory assessment and verification of installation-level decarbonisation investment plans, while still ensuring that the economic value of free allocation translates into actual decarbonisation investment.

[4] 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

Such an approach would build on precedents found in State aid frameworks, where investment-related conditionalities can be linked to eligible expenditure and demonstrated through existing reporting and verification mechanisms.

Under this pathway, operators would:

- Not need to draw up installation-level plans, submit them or have them approved.
- Instead, be required to demonstrate, at corporate or group level, that they have directed an amount equivalent to (a certain proportion of) the economic value of their free allocation towards industrial decarbonisation, using a combination of existing financial disclosures and recognised certification schemes.

It could therefore provide a simpler and more proportionate means of implementing investment conditionality while maintaining accountability for the use of the economic support provided through free allocation.

Accepted disclosures/schemes would need to be defined. They could include (non-exhaustive):

- Corporate financial indicators: Verified decarbonisation-related capital CAPEX and operating expenditure OPEX, including EU Taxonomy-aligned investments, reported through existing Corporate Sustainability Reporting Directive (CSRD) disclosures where applicable, or equivalent audited financial statements.
- Certified green financing instruments: Proceeds from European Green Bonds, independently verified green bonds, sustainability-linked financing and dedicated transition-finance instruments, provided that the funds are demonstrably allocated to eligible decarbonisation investments in the EU.
- Dedicated clean-technology investments: Equity investments, capital contributions or other financial commitments to EU-based clean-technology projects, joint ventures, industrial decarbonisation initiatives or dedicated investment funds.
- Low-carbon energy certificates and procurement: Guarantees of Origin (GOs), renewable-energy certificates and long-term renewable Power Purchase Agreements (PPAs), where they demonstrate qualifying investments in additional renewable-energy capacity or other eligible decarbonisation activities.
- Recognised investment certifications: Independently certified investment programmes, EU Taxonomy-aligned projects, or projects approved under established EU funding mechanisms, including the Innovation Fund and other EU industrial decarbonisation instruments.

This approach would preserve the objective of directing the economic value of free allocation towards industrial decarbonisation in Europe, while reducing administrative burden for Member States and businesses, and improving investment flexibility.

4. Concluding remarks

While we fully agree with the objective this approach seeks to achieve, i.e. keeping industrial investment inside the EU and accelerating decarbonisation, the tool is not the one we would recommend, from either a conceptual or an operational perspective. Free allocation should remain an instrument that addresses the risk of carbon leakage, and this approach, in our view, detracts from its effectiveness.

If free-allocation conditionality were to be retained, at a minimum it would need to be accompanied by conditions regarding the technical feasibility and economic viability of the decarbonisation measures, and the existence of the external conditions for decarbonisation (double conditionality).

Two alternative pathways can be considered. The first is a positive conditionality pathway, in which 100% baseline free allocation is kept, but an additional bonus layer of free allocation is given to reward installations that voluntarily submit a verified plan and successfully deliver verified decarbonisation milestones. The second pathway entails a simplified and flexible approach to demonstrating decarbonisation investments. Instead of drawing up installation-level plans, submitting them and having them approved, operators would be required to demonstrate, at corporate or group level, that they have directed an amount equivalent to (a certain proportion of) the economic value of their free allocation towards industrial decarbonisation, using a combination of existing financial disclosures and recognised certification schemes.

A political consensus or compromise is necessary, but it also needs to be one that addresses all the issues. Too much is at stake.