

ERCST Reflection Note

EU ETS Review: Initial Reactions to the July 2026 Proposal

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Initial Reactions to the July 2026 Proposal

ERCST's Reaction

- This is a broad initial reaction to the Commission Proposal, with on-going analysis to follow on specific issues.
- 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 the paper that it released before EC proposal¹, ERCST had emphasized four areas in which the EU ETS would need to be managed:
 1. Price and market functioning
 2. Cost of compliance
 3. Relationship with external conditions
 4. International credits and CDR
- 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. 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 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).

¹ ERCST (2026), Review of ETS – Managing the EU ETS for Decarbonization, <https://ercst.org/managing-the-eu-ets-for-decarbonization/>

- 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 skeptics 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.

Reaction by Jean-Yves Caneill, ERCST Senior Fellow

It had been hoped that the draft revision of the EU ETS would mark a decisive step in the pathway taken by the European Union to decarbonize its economy until "carbon neutrality" by 2050, at least as far as the electricity sector and large industry are concerned. Indeed, since 2005, the European carbon market, considered as the cornerstone of European climate policy, has certainly delivered a significant carbon price, but few real investments.

It appears that the emission reductions in the electricity sector have been significant, but mainly due to renewable energy subsidy policies. The carbon price has been driven by the risk hedging policies of electricity companies that manage three-year electricity supply contracts. It is therefore the short-term marginal costs that have played a role in the formation of the carbon price, very often allowing the use of gas rather than coal in electricity production. The treatment of industry through the adoption of benchmarks and the issuance of free allowances (related to its competitiveness) has not yet allowed for a real transformation towards decarbonisation.

A reform of the EU ETS should therefore focus on transforming the system into a long-term framework with appropriate governance to promote a carbon price that reflects the long-term marginal costs, i.e. the capital costs of the investments needed to decarbonise installations subject to the ETS.

How does the draft revision of the EU ETS, published on Friday, July 17, 2026, addresses these concerns?

A first point that can be considered positive is that the basic text, i.e. the reform of EU ETS is published together with other texts, in particular a communication on the electrification of Europe, which shows that the Commission is beginning to take into account certain issues related to deindustrialisation of Europe that has been observed for several decades. We are still far from a holistic understanding of all the subjects, but this is a point to be welcomed.

The EU ETS Directive contains several points that deserved to be highlighted, and we encourage the reader to look at what is emphasized in the present paper. Several questions arise when reading this Commission proposal:

- The 2050 horizon of the Green Deal, reaffirmed by the Climate Law, is not part of a major reform of the EU ETS, which would have provided structural visibility to regulation so that carbon prices could gradually reflect investment costs
- Under these conditions, is there not a risk that the price of carbon will be driven by short-term signals, in particular the prices of fossil fuels, while they will be less and less present in the European energy system?
- Will the "redesigned" MSR be sufficiently resilient to more time-bound risk hedging practices if they occur?

To conclude, we will say that the proposal removes a number of uncertainties that have existed for several months in the European debate: reduction targets, the MSR, the international credits of the Paris Agreement, etc. On the other hand, the sustainability of the carbon market as a source of financing for the transition is far from settled. There are many positive points in this regulatory corpus, but it would be desirable for the Commission to start thinking about the post-2040 period now, to build a more resilient carbon market with a more solid strategic governance. This reflexion is necessary because there is a risk that we move progressively to a more "command and control" regulation after 2040, which could be more costly. Many countries have adopted ETS regulation in their climate policies taking example on EU. One needs to keep the flexibility of markets for time to come when international cooperation will be crucial to fill the Paris Agreement goals.

Reaction by Philippe Chauveau, ERCST Founding Member

- The proposal brings together strategic add-ons to the current design of the ETS (IDB, inclusion of CDRs and international credits, scope extensions) and parametric recalibrations (LRF, benchmarks, CBAM phase-in...) for the priorities identified from now until 2040, with industry's competitiveness and the transition to net zero in the front row.
- Yet governance is untouched with automated corrections although managing conditionalities between the ETS and other climate and energy policies are known to be complex and a necessary condition in the years ahead. It paves the way for more regulatory interventions in the years to come, which anticipation generally tends to delay investment decisions in board rooms. Introducing a more agile governance, such as the carbon central bank proposed by ERCST, would be a bolder step meant for addressing this and aligning with policy impulses to frontload and support decarbonized investments (IDB, Electrification Action Plan, national plans).
- Finally, if the direction proposed for MSR parametric adjustments is generally meaningful, forward-looking attention is needed on the level of the lower threshold and buffer, particularly in the light of hedging needs expectable in the years to come with CBAM phase-on and long-term hedging being cases for strategic disruptions from historic trends, while the supply-demand balance is unseen since 2008 and all sectors are short.

Reaction by Olivier Imbault, ERCST Senior Fellow

The European Commission has just published two proposals: the first concerns the revision of the ETS, and the second is an action plan to accelerate the electrification of Europe. The goal of these two proposals is to “boost Europe’s competitiveness, decarbonization, and independence.”

The two proposals address an obvious need: the climate transition is proceeding much more slowly than Europe had hoped, as it underestimated the technical challenges and costs for businesses, as well as public acceptance, and failed to anticipate the paradigm shift in the global economy.

However, they fall far short of providing a solution to boost Europe’s competitiveness or even ensure its independence.

They introduce a parametric adjustment to the regulatory framework to align it with reality and the EU’s new objectives, particularly for the ETS, with 16 measures concerning the emissions reduction trajectory, international credits, CDRs, the MSR, the extension of free allowances by making them conditional on a decarbonization plan, the strengthening of financing mechanisms while preserving solidarity among member states, specific measures for air and maritime transport, specific measures to simplify administrative authorizations, and finally a more measured plan for integrating waste incineration into the ETS.

All of these measures make sense and bring flexibility to the ETS model. They will certainly have an impact on the climate transition, but it is better to manage the challenges than to be forced to deal with the reality. However, they will have limited impacts on competitiveness; indeed, these are merely regulatory adjustments and by no means an industrial strategy (which is left to the member states), and the action plan on the electrification of Europe will not be sufficient for “hard-to-abate” sectors, such as the chemical industry, nor will it protect Europe from massive imports from China, particularly in the mobility sector.

Three things are missing:

1. Regarding competitiveness, a genuine level-playing-field policy for industry with a CBAM—mentioned in the proposal on the revision of the ETS—that will clearly and definitively address the issue of exports, as the solution of extending free allowances is only a temporary measure.
2. Regarding the functioning of the ETS and the MSR, a greater flexibility to adapt to market realities by establishing a governance structure—such as a carbon bank—to complement a purely parametric mechanism.
3. Regarding the effective implementation of these regulatory changes, a real European industrial strategy addressing all key industrial sectors, particularly the chemical sector, which has been sidelined in the Industrial Accelerator Act.

Overview of the EU ETS Review Proposal

Background

The 2023 EU ETS review introduced several review clauses mandating a 2026 assessment of potential adjustments of the rules for aviation, maritime, and stationary installations (Articles 3gg, 28b, and 30). In addition, Article 3 of the MSR Decision legally requires a comprehensive review of the Market Stability Reserve in 2026.

The July 2026 EU ETS review proposal introduces measures based on an impact assessment conducted to address the above review clauses.

Sectoral expansion

1. **Waste:** Gradual extension to cover waste incineration from 2031.
 - The extension will apply to emissions from non-hazardous waste incineration installations with a capacity exceeding 3 tonnes per hour. The obligation to surrender allowances in the municipal waste incineration sector will be gradually phased in over the period 2031 to 2034, with municipal waste incineration installations obliged to surrender 100% of their verified emissions as of 2034 (Article 12a). This extension requires gradual adjustment of cap between 2031-2034 (amended Article 9), i.e. by 10.2 million allowances in 2031; 19.5 million allowances in 2032; 28.1 million allowances in 2033; and 36 million allowances in 2034.
 - To monitor unintended impact from the extension to waste incineration, the proposal adds disposal or recovery of non-hazardous waste in landfills as a new activity for the purpose of monitoring, reporting and verification.
2. **Aviation:** departing international flights that land in countries within 5000 km from the largest airport in the geographical centre of EU will be brought into the EU ETS from 2029. This strategically aims at covering flights departing to the immediate EU neighbourhood, while keeping out flights headed to China or the U.S.. This extension is accompanied by commensurate increases in the cap (amended Article 28a(1)).
3. **Maritime:** extension to small vessels below 5000 gross tonnage but not below 400 gross tonnage. This extension requires the cap to be increased (amended Article 9)

Cap/LRF

The proposal puts forward a post-2030 EU ETS LRF trajectory in line with the EU's 2040 target of a 90% emissions reduction (amending Article 9). As a result, carbon allowances will continue to be issued into the 2040s.

- 2024-2027 (current legislation /for reference): 4.3%
- 2028-2030 (current legislation/ for reference): 4.4%
- 2031-35 (proposed): 3.7%
- 2036-40 (proposed): 1.7% (with international credits); 2.7% (fallback in case high integrity international credits do not become available)

Market Stability Reserve (MSR)

MSR parameters will be adjusted to the shrinking market:

- From 2029 onwards, the upper threshold, lower threshold and corresponding buffers and the release quantity will be adjusted annually and reduced with 4% to remain aligned with the evolution of the shrinking market
- To spread intakes over a longer period, the upper buffer threshold needs to be adjusted downwards to 947 mln from 2028 onwards to reflect the reduced intake rate
- The proposal also introduces a new “lower buffer” from 2028, replacing the current cliff-edge release mechanism with a gradual release of allowances as the number in circulation falls between 300 mln and 400 mln, before the full emergency release applies below that level.
- The calculation of the Total Number of Allowances in Circulation (TNAC) will incorporate historic aviation demand. At present, TNAC only reflects stationary installations up to 2023 and aviation from 2024 onwards. The proposal says future TNAC calculations will also include aviation demand from 2012-23.
- The intake rate will be 12% from 2028 onwards instead of the current 24% when the TNAC is above 947 mln.
- Under a separate proposal (April 2026) allowances above 400 mln will not be automatically invalidated, but rather kept in the MSR.

Carbon removals (proposed new Article 9c)

- It will introduce 250 million tons of domestic removal units between 2031 and 2040.
- Practically it is proposed to incorporate permanent carbon removals into the EU ETS by:
 - Increasing the cap by 250 million allowances, assigned for the purchase of removals between 2031 and 2040.
 - Making these allowances available to the Commission to auction them from 2031 to 2040 to generate revenues for the purchase of an equivalent amount of domestic permanent carbon removal units generated by BioCCS and DACCS.
 - Allocating to the Commission an additional 10 million allowances, the auctioning revenues of which would be used to address the price gap between removals and allowances.
 - The net EU ETS target would be calculated as the gross emissions (corresponding to the total amount of allowances) minus the amount removals planned to be purchased.

International credits (proposed new Article 9b)

- Up to 260 million allowances will be made available in 2036-2040 to a facility for the purchase of up to 260 Mt of high quality and high integrity international credits.
- This reduces the need for domestic abatement of up to 5 percentage points in 2040, which corresponds to 260 million tons. This translates into additional domestic emission space for ETS sectors.
- This is operationalised through proposing a lower than otherwise LRF as of 2036 of 1.7% (rather than 2.7%) aligned with reaching an ambition of 85% EU domestic emission reductions by 2040, while setting aside allowances equal to the EU ETS ambition reduction (260 Mt) to fund the purchase of international credits.

- A fallback mechanism is proposed in the event high-integrity international credits are not available, whereby the trajectory for ETS sectors reverts to being aligned with an EU domestic reduction of 90% by 2040. If this is the case, the LRF would revert to 2.7% from 2036. The application of the mechanism will be subject to the report from the Commission on the development of a high-quality and high-integrity international credit market.

Revenues earmarking to newly defined priority areas

- It is proposed that Member States be required to allocate at least 50% of the revenues to newly defined high-priority areas.
- The proposal defines priority areas for spending, reflecting the principle that ETS sectors paying the carbon price should be supported with the revenues the ETS raises.
- These priorities include:
 - topping up the support mechanisms in this Directive for reducing climate impacts from ETS sectors;
 - clean energies, electricity storage and grids, low-carbon transport (incl. maritime and aviation);
 - industrial decarbonisation (including electrification, CCS and clean tech);
 - waste management decarbonization;
 - circularity;
 - supporting the development of lead markets for low-carbon and circular products such as bio-based fertilisers, bio-based chemicals or green steel;
 - supporting research and innovation in these areas.
- Complementary amendments to the upcoming Governance Regulation will require Member States to integrate their planned use of ETS auction revenues into their NECPs.

Industrial Decarbonisation Bank incl. Investment booster

Industrial decarbonisation investments are often lacking a bankable business case.

This is why the Clean Industrial Deal announced the Industrial Decarbonisation Bank (IDB), with EUR 100 billion in funding. The IDB aims to promote the scale-up and roll-out of more mature industrial decarbonisation projects, notably in Energy Intensive Industries (EIIs) across all Member States, to be funded mostly by reserving a certain share of ETS allowances.

To kick-start such investments and drive long-term competitiveness, the ETS Investment Booster will be available already before 2030 to ensure timely support.

IDB has thus a two-step financing architecture:

- 2028–2030: the ‘Investment Booster’ will reserve 400 million allowances to provide fixed carbon premia using a ‘first in, first served’ system to fast-track investments on the basis of speed (new Article 10cd). A dedicated share will be reserved for lower-income Member States to ensure solidarity. Support will be conditional on compliance with strict completion deadlines and performance will be guaranteed through the issuance of completion bonds. Payments will be linked to independently verified emissions avoidance and may be delivered in allowances.

- Post-2030: the full Industrial Decarbonisation Bank will support projects, mainly through competitive bidding procedures that award Carbon Contracts for Difference or carbon premiums, thereby providing long-term revenue stability and de-risking investments

Free allocation conditionalities and clawback

- Free allocation (and indirect carbon cost compensation) will continue beyond 2030, but will be conditional.
- An “investment conditionality” will replace the three existing conditionalities, and will run on five-year cycles. Of the eligible free allowances:
 - 80% will be given for free after companies publish plans for decarbonization investments that are endorsed by the company board and published.
 - The remaining 20% will be given after the implementation and publication of the investments and related emissions reduction.
- Investments can be grouped at the corporate level, not at installation level.
- 10% best performers will be exempted from this conditionality.
- Verification of the company decarbonization plans and investments will be done primarily at the member state level, with occasional checks at the EU level.
- Clawback in case of delocalisation outside EU.

Product benchmarks for 2031-2040

- It is proposed to extend the current carbon leakage instruments (free allocation, carbon leakage list) to support certain EIIs at risk of carbon leakage until 2040.
- The proposal also sets rules on the update of the benchmark values for the periods 2031-2035 and 2036-2040, thereby extending the principles of the current methodology into those periods.
 - More specifically, to ensure appropriate protection against the risk of carbon leakage and ensure sufficient free allocation levels better reflecting the actual decarbonisation pathway of industrial sectors for the period from 2031 to 2040, the same minimum update rate percentages as for the ongoing period (of 0,3 %) should also apply from 2026 to 2030, while the maximum update rate percentages for the same period should be adjusted to 2 % (down from the current 2,5% in 2026-2030).

Revised Heat and Fuel benchmarks

During phase 4 (separate proposal):

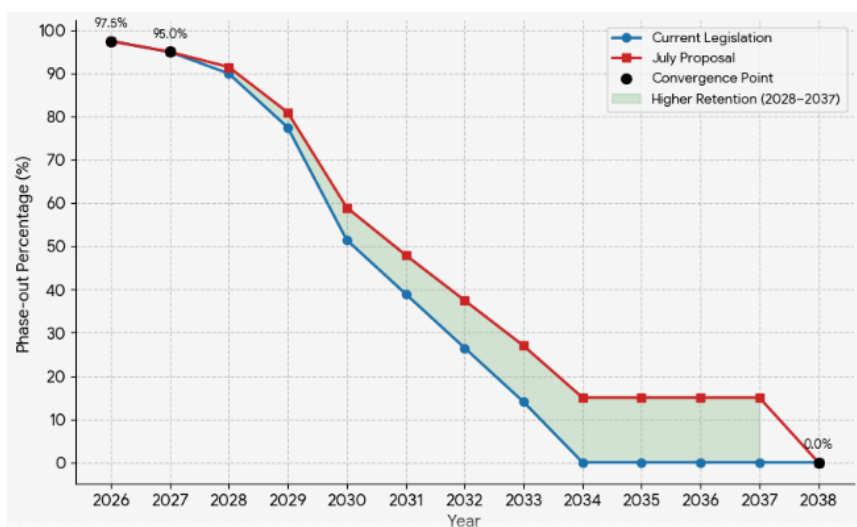
- Less stringent maximum annual update rate of the heat and fuel benchmarks until 2030.
- More specifically, the adjusted percentage rate value to be applied will reflect the highest possible upwards adjustment to free allocation levels determined by the heat and fuel benchmarks by fully using the available allowances that can be allocated free of charge for 2026 to 2030, amounting to around 80 million allowances, while at the same time not triggering the application of the cross-sectoral correction factor.
- It is intended that this separate proposal be fast-tracked independently from the ETS review, at the request of EU Member States.

Post-2030 (upcoming proposal):

- Possibility of introducing sector-specific fallback benchmarks after 2030, to take into account the different situations or difficulties in decarbonization.
- The Commission would be empowered to define sector-specific fallback benchmarks after 2030 and establish a methodology for determining the respective benchmark values.

Free allocation phase out schedule for CBAM sectors

- For CBAM sectors, the reduction of free allocation is slowed and the full phase-out pushed from 2034 to 2038.
- Specifically, 15% of the free allocation otherwise removed by the CBAM factor is reintroduced from 2028, slowing the pace at which CBAM is phased in.



CBAM factor	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038
Current legislation	97.5%	95%	90%	77.5%	51.5%	39%	26.5%	14%	0%	0%	0%	0%	0%
July proposal	97.5%	95%	91.5%	81%	59%	48%	37.5%	27%	15%	15%	15%	15%	0%

CBAM exports provision

- CBAM levels the playing field only for imports, leaving EU exporters exposed as free allocation falls². The December 2025 package covered this temporarily via the Temporary Decarbonization Fund, with a permanent export solution deferred to this review.
- The EU ETS review adds no dedicated export instrument: the additional free allocation above is presented as the carbon-leakage protection for CBAM industries, meaning a separate fund to support their exports on international market to replace the Temporary Decarbonisation Fund is no longer needed.

² For an overview of the export problem and a detailed ERCST analysis, see A. Marcu et Al., *Solutions for exports of EU CBAM-covered goods*, ERCST, available at <https://ercst.org/solutions-for-exports-of-eu-cbam-covered-goods/>.

Key review clauses

Aviation:

- Review clause for CORSIA's assessment in 2032.

Maritime:

- The proposal provides for a review of the EU ETS in the event of the adoption of an IMO global measure to avoid the risk of double payments while preserving the environmental integrity of the EU ETS.
- By 31 December 2031 the Commission shall present a report examining the feasibility and impacts of the inclusion of emissions from ships, below 5 000 gross tonnage but not below 400 gross tonnage.

Carbon removals:

By 31 December 2034, the Commission shall present a report:

- assessing the progress regarding the purchase of domestic permanent carbon removal units,
- examining the possible contribution of nature based removals and carbon farming sequestration units to permanent carbon removals, and
- assessing the feasibility to gradually transition, from an integration managed by the Commission, towards a direct integration by operators, beyond own use, of domestic permanent carbon removal units in the EU ETS.

International credits:

- By 31 January 2033, the Commission shall present to the European Parliament and to the Council a report assessing the development of a high-quality and high-integrity international credits market.

Waste:

- By 31 December 2034, the Commission shall present a report taking account of relevant developments in terms of waste diversion contrary to the waste hierarchy and assessing the inclusion in the EU ETS of emissions from landfills and where appropriate accompany that report with a legislative proposal.

ETS1 and ETS2 linking:

- ETS2 is excluded from the scope of this proposal. The application of the ETS2 is due for review by 2029, and any assessment of the feasibility of integrating the sectors under ETS2 into the EU ETS is due by 2031.