

ERCST Report

Managing the EU ETS for decarbonization

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Managing the EU ETS for decarbonization

- The EU ETS is currently focused on managing EUA prices, with the MSR the instrument that has that role.
- Changes in the EU ETS environment make it necessary to manage more than prices and include
 - Price and market functioning,
 - Costs of compliance,
 - Articulation of EU ETS price signal with the necessary external conditions for decarbonization
 - The flexibility needed for introducing international credits, for the cost of compliance, and CDRs, for reaching net-zero.
- Given the complexity of managing all these elements, a new governance is necessary that is flexible and does not rely on mathematical formulas only.
- A modified and enhanced MSR is a good candidate for such a function.
- The implementation of measures related to market functioning can be done in the short term without disrupting the market and is a necessary (but not sufficient) change.
- Implementation of changes in architecture and governance is more disruptive and requires more time and, therefore, cannot simply be postponed to the next review.
- The introduction of short-term measures related to market functioning only is likely to lead to the increased use of one-off regulatory interventions that will lead to a lack of predictability and a general lack of trust in the stability of the EU ETS. We need market decisions that are made on a good and predictable governance.

Ultimately, this paper will compare what ERCST sees as the elements that need to be part of the review of the EU ETS with the actual Commission proposal that will be put forward on July 17, 2026.

It contains three main chapters:

- **Chapter 1**: Set a baseline of what ERCST thinks is necessary, and possible, depending on the timeframe (short-term and medium to long-term)
- **Chapter 2**: Analyze the Commission Proposal and decompose it into the elements that were identified in Chapter 1.
- **Chapter 3**: undertake a comparative study between the findings in Chapters 1 and 2.

In the present (partial) release of the paper, content is limited to Chapter 1 only.

Chapter 1

The following chapter 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.

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 (signaled 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:
 - **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.
 - **Costs of compliance**, which impacts competitiveness.
 - **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.
 - **Flexibility for the introduction of CDR** for net zero and international credits.

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.

2.2. 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.

2.2. 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.

2.2. Cost of compliance

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

3. Changing circumstances in which EU ETS functions and decarbonization

ERCST has examined in depth¹ 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.

¹ See [EU ETS Review: Issues and Levers – ERCST](#)

- 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.

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

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.

4.2. 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 3 above, additional elements need to be managed, which is more complex.

4.2.1 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 consideration².

Price volatility

Art 29 a 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.

4.2.2 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

² See <https://veyt.com/wp-content/uploads/2025/10/EU-ETS-Market-Stability-Reserve-review-Flexibility-is-the-magic-word-4.pdf>

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 truism³ 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.
 - 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:

³ See ERCST (2026), Carbon Leakage under CBAM and Free Allocation <https://ercst.org/carbon-leakage-under-cbam-and-free-allocation/>

- A lower LRF that will ensure additional free allocation. Changes to the LRF, making it more realistic and extending the EUAs past 2039, such as proposals from the EUP for a lower LRF 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 for consistency and coherence.

4.2.3 Managing the conditionality of external conditions

Need to manage articulation with external conditions

- The EU ETS was put in place to manage 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 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.

Governance

- Managing such conditionality, 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.

4.2.4 Managing the conditionality of external conditions

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.

Governance

- A special instrument with flexible governance will likely be required for international credits at least in the pilot phase envisaged in 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.
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