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KEEP THE ETS ON TRACK

RECOMMENDATIONS FOR THE REVISION OF THE EU EMISSIONS TRADING SYSTEM (ETS1)

JUNE 2026

Recommendations for the ETS review: Ambition must be maintained to drive Europe towards a clean industrial future

Key recommendations:

1. Protect the integrity and ambition of the EU ETS as a key driver of industrial transformation.
2. Maintain the ambition of the Linear Reduction Factor until at least 2035.
3. Maintain free allocation phase out for all ETS sectors by 2034 and introduce conditionality to ensure installations invest in emissions reduction measures in line with the EU climate goals.
4. Mandate a more effective and traceable use of ETS revenues towards genuine climate action, with a transparent, harmonised methodology.
5. Widen the scope of the ETS to include international aviation and municipal waste incineration.
6. Keep international credits and Carbon Dioxide Removals (CDR) outside the ETS to avoid risks to functioning of the system and prioritise emissions abatement over removals.
7. Avoid snowball effect of multiple tweaks leading to a weak carbon price and oversupply, rendering the instrument ineffective.

Maintaining ambition for genuine, future-proof competitiveness

This ETS review comes as the EU is in the midst of another energy crisis driven by its continued dependency on fossil fuels. High energy prices, primarily caused by the EU's dependency on fossil imports, have led to calls to weaken the ambition of the ETS in a bid to provide 'relief' to European industry. However, **the notion of offering short-term 'relief' to industry by weakening ambition of the ETS is extremely short-sighted**. Weakening the ETS would do little to reduce energy prices but instead create the risk of so-called 'decarbonisation leakage' as Europe misses out in the clean industrial race. Such a move would also worsen the long-term impact to European society caused by continued fossil fuel dependence, which the ETS is helping to mitigate. In Spain for example, commitment to the energy transition, sparked by the ETS, has acted as a shield against price impacts of volatile fossil fuels.

The trajectory of the emissions cap in the ETS is set by the **Linear Reduction Factor (LRF)**. Reducing the ambition of the LRF now would penalises early movers, jeopardising the investments in clean industry that need to take place now. Maintaining the ambition of the cap trajectory is vital to reward first-movers in industrial decarbonisation and provide a stable and long-term investment case for low-carbon industrial technologies and renewables. A declining carbon budget also offers the opportunity to break free from fossil-fuels dependence, making our society less vulnerable from geopolitical shocks. **The environmental and social savings from transitioning away from fossil fuel combustion are enormous, and the ETS is the key driver of this change.**

Alterations to the cap must also be viewed in the context of achieving the EU's legally binding climate targets. Allowing additional emissions from sectors covered by the ETS means more reductions would be needed elsewhere, likely in sectors which have a more direct impact on prices directly faced by European citizens. Maintaining the current ambition is necessary to enforce the polluter pays principle.

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International non-profit association ● Association internationale sans but lucratif (AISBL) ● EC register for interest representatives: ID number: 06798511314-27 ● BCE ID number: 0415.814.848 ● RPM Tribunal de l'entreprise francophone de Bruxelles

We therefore support calls for any changes to the cap to be 'carbon budget neutral'. **A possible relaxation of the LRF from 2036 to allow for 'residual' emissions after 2040 should only be considered if coupled with either a more stringent LRF or additional Market Stability Reserve (MSR) intake before 2040**.

Recommendations:

- Maintain ambition, as set by the current LRF, at least until 2036
- Make any changes to the LRF beyond this point 'carbon budget neutral'

Free allocation: Conditionality needed, with no extension beyond 2034

Free allocation of allowances was intended to mitigate the risk of carbon leakage. However, this practice has had other damaging consequences and must be phased out. As recognised by the European Court of Auditors, **free allocation mutes the carbon price signal, reducing incentives to invest in decarbonisation**. Furthermore, by handing out these freebies, **the Commission continues to put the cost of emitting on society** while depriving Member States of ETS auctioning revenues, key to increase public spending in climate action.

Extending free allocation is also incompatible with the phase-in of the Carbon Border Adjustment Mechanism (CBAM). Maintaining any free allocation alongside a full phase-in of CBAM would provide double protection to CBAM sectors, which would be incompatible with WTO rules. **Therefore, the timeline regulating the free allocation phase out for CBAM sectors must be respected**; extending free allocation beyond 2034 would undermine the CBAM's rationale and the business cases of early movers in Europe.

Additionally, **free allocation should no longer be a de facto subsidy for industry and should instead be made conditional to real investments in decarbonisation within the EU**. Presently, only the 20% worst emitters are subject to any conditionality under the Climate Neutrality Plans (CNP), and only 20% of their free allocation can be taken away in case of non-compliance. Instead, investment in decarbonisation should become mandatory for all ETS installations to receive their free allocation. Requirements under the CNPs could be based on criteria set out under the Clean Industrial Deal State Aid Framework (CISAF) to prevent fossil fuels lock-ins, while legal proof of investments made could be provided via monitoring reports sent every year, in line with the approach set out in the proposal for the Temporary Decarbonisation Fund. Synergies with Transformation Plans and Deep Industrial Transformation requirements under the Industrial Emissions Directive (IED) could also be leveraged.

Importantly, the benchmarks which determine the amount of free allocation provided to industrial operators, must be increasingly stringent. The Commission has indicated it will introduce new **sector-specific fallback benchmarks** to appease industrial concerns. These benchmarks must reflect the reality of emissions reductions that have taken place in each sector and be sufficiently ambitious to ensure incentives exist for installations to reduce their emissions.

The current benchmark revision has also again highlighted the need to revise and update benchmark definitions. Moving further towards 'one product, one benchmark' approach would align better with the embedded emissions approach developed for the CBAM and help to ensure a truly level playing field between European and overseas installations as CBAM is phased in and free allocation is phased out.

Existing product benchmark definitions should also be improved to recognise the emergence of new technologies and avoid disincentivising circular practices. Additionally, the ETS benchmarks should be transparently used in standards making, such as in the best available techniques (BAT) reference documents pursuant to the IED, which aims to set standards for decarbonisation along with other goals relating to emission reduction and prevention. For further details, see our response to the recent consultation on benchmark updates.

Recommendations:

- Maintain free allocation phase out for all ETS sectors by 2034.
- Introduce conditionality to ensure installations receiving free allowances invest in emissions reduction measures in line with the EU climate neutrality goal.
- Ensure sector-specific benchmarks are sufficiently ambitious to drive emission reductions and move towards a 'one product, one benchmark' approach.

Making better use of ETS revenues

The auctioning of allowances in the ETS creates revenues which have been funnelled into Member States' pockets rather than being used to drive decarbonisation. For instance, in Italy, just 9% of auction revenues were allocated to climate action between 2012 and 2024. Although the previous ETS review mandated that 100% of revenues should be used for climate and energy purposes, the **attribution of spending for climate action remains vague** and revenues can still be used to compensate energy-intensive industries for indirect carbon costs. The Commission must look to introduce harmonised templates for spending for full transparency and strengthen its ability to enforce a more targeted use of these revenues in line with the EU climate targets.

New instruments which use these revenues for climate action such as the proposed Industrial Decarbonisation Bank are welcome but, at the same time, there is room for improvement in existing instruments like the Innovation Fund. The European Court of Auditors have highlighted this Fund still suffers from slow deployment and less than expected emission reductions. As well as financing decarbonisation projects, the Commission must also earmark ETS revenues towards **facilitating a just transition**. This should include activities like reskilling workers affected by the transformation of the economy, and compensating citizens who will be impacted by higher prices.

Recommendations:

- Ensure ETS revenues are actually being used for climate action.
- Improve functioning of existing financing instruments towards driving climate action.
- Earmark revenues for just transition, resilience and adaptation activities.

Extend ETS scope to include international aviation and waste incineration

In addition to maintaining ambition for covered sectors, there is a need to expand coverage to include activities which are currently out of scope of the ETS. **International aviation** has been outside the scope since the 'stop the clocks' decision in 2012. It was hoped the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), introduced by the International Civil Aviation Organisation (ICAO), would address emissions from all international flights, including those to and from Europe.

However, the CORSIA system has proven to be ineffective, suffering from limited scope, incomplete enforcement, and focus on low-quality offsets rather than real emission cuts. The EU must extend the scope of the ETS at least to cover all flights departing airports in the European Economic Area. This would have the added benefit of boosting ETS revenues from €3 billion to €7 billion , which could be used to accelerate decarbonisation of the sector.

Municipal waste incineration (MWI) is a significant source of carbon emissions while contributing little to a circular economy, as recognised by the European Commission in the context of the Taxonomy Regulation. Waste incineration emits around 95 million tonnes of CO_2e annually in the EU. Including waste incineration in the EU ETS would not only address its climate externalities by reducing CO_2 emissions by 4 to 7 million tonnes in 2030, rising to 18 to 32 million tonnes in 2040, but also **support the objectives of the EU waste hierarchy** by strengthening incentives for waste prevention, high-quality recycling, and efficient resource use. It would also avoid distortions between treatment options, given that co-incineration in power plants is already covered by the ETS.

The importance of including incineration in the ETS to support secondary materials markets and strengthen the EU's resource independence was also highlighted in the Draghi Report. Recent evidence further suggests that concerns about unintended consequences, such as increased landfilling, are limited. Environmental NGOs and industry stakeholders have therefore long called for the inclusion of waste incineration in the ETS.

Recommendations:

- Include international flights, at least those departing the EU, within the scope of ETS.
- Include MWI within the scope of ETS.

No international credits or carbon removals through the backdoor

The EU must not repeat past mistakes by allowing **international credits** to interact with the ETS. In phase 3 (2013-2020), over 1.6 billion international credits entered the ETS leading to a weak price signal and a significant oversupply of allowances. This has delayed emission reductions and damaged the effectiveness and credibility of the ETS. While the Kyoto Protocol's Clean Development Mechanism (CDM) has been replaced by the Article 6 framework, concerns over the quality of these credits persist; therefore, any interaction with the ETS must be avoided.

Similarly, the integration of **carbon dioxide removals** (CDR) represents a risk to the functioning of the ETS. Proponents of this integration claim it would stimulate demand for CDR and help improve the liquidity of the market. However, studies have shown there is no need to integrate CDR into the ETS in the short- to medium-term. There are fundamental differences between emerging CDR technologies and industrial emissions abatement, which create risk. Nurturing these nascent removal technologies in a market designed for emissions abatement is a challenging undertaking which would create huge uncertainty for ETS installations. Attempting to manage the supply of CDR would negate the benefits of integrating into the market in the first place.

Interaction of CDR with the ETS could be considered from the late 2030s to compensate for the very last 'residual emissions' in the system and move towards 'net negative' emissions. However, what constitutes these residual emissions must first be strictly defined and quantified as those that are left over after all abatement options have been used.

Therefore, it is highly premature to consider any interaction of CDR with the ETS at this stage. The EU needs to rapidly and drastically cut greenhouse gas emissions as a first priority. Even an indirect interaction with CDR, for example via the MSR, introduces unnecessary complexity and risks undermining the core function of the ETS. While CDR will be necessary to meet the EU's climate goals, these technologies should be developed outside the ETS, especially since the Commission is already introducing instruments that will stimulate demand for CDR and question marks remain over the scheme developed to certify CDR.

Many CDR technologies also rely on the fact that combustion of biomass has a zero-rating within the EU policy framework a flawed approach which must be revisited before CDR integration is considered. This assumption means that the ETS does not price CO_2 from combustion of biomass, creating a perverse incentive to burn biomass by disregarding the long-lasting carbon debt created by this practice. This outdated assumption must be revisited, regardless of whether CDR is integrated.

Recommendations:

- Avoid oversupply by keeping international credits well away from the ETS.
- Ensure emissions abatement remains a priority by developing CDR outside the ETS to avoid unnecessary complexity and risks to market functioning.

Too many tweaks risks return to ETS dark ages

The Commission have expressed its intention to weaken ambition in several key design areas, from loosening the trajectory of the cap and extending free allocation to scrapping the invalidation clause and "increasing the firepower" of the MSR. There is a high risk that, when taken together, these **changes, which might appear small individually, end up having a major impact on the functioning of the instrument**.

As a market-based instrument, the ETS is characterised by a balance between supply (of allowances, determined by the trajectory of the cap and the number of allowances which could be released from reserves) and demand (from industrial emitters). **The risk of a shortage of allowances in the near term has been overstated**; the market is still in a state of oversupply after decades of unambitious design choices, including allowing international credits to flood the market. Moreover, it is expected to remain oversupplied until 2036 under current rules. Only minor tweaks, if any, are needed to see the market through to 2040 and the ETS 'endgame'.

For instance, estimates suggest that scrapping the invalidation clause in the MSR could already lead to the equivalent of 656 $MtCO_2$ in additional emissions from the ETS. As recently shown by Oeko-Institut, tweaking additional design elements would create a **risk of chronic oversupply** of the market. This large surplus would depress the carbon price and stifle investments in low-carbon and future-proof industrial processes, condemning EU industry and society to a perpetual reliance on uncompetitive, vulnerable and polluting fossil fuels and jeopardising attainment of the EU's climate goals.

Research has highlighted the importance of credible long-term scarcity signals to the functioning of the market. The ETS works now because of the anticipation of a constrained supply of allowances in the future. **To preserve the system's functioning and credibility, ambition must therefore be maintained across all ETS design elements**.

Recommendations:

- Do not view changes to the ETS design in isolation.
- Consider the knock-on impact that design changes will have on the carbon price and the subsequent impact on investment decisions, particularly for early movers.
- Consider the impact weakening ambition would have in terms of continuing reliance on fossil fuels and the vulnerability of EU industry and society to geopolitical shocks.

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