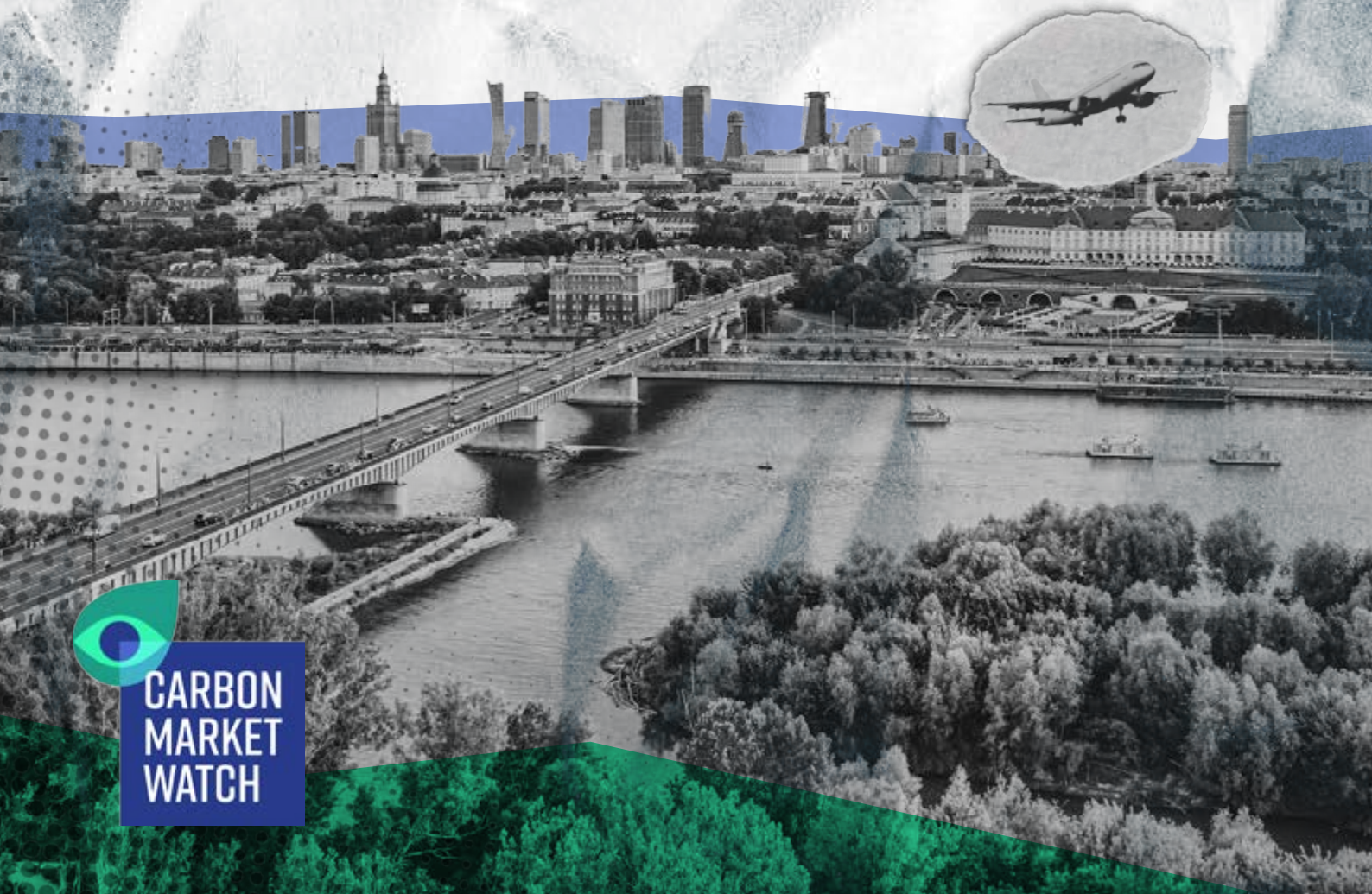
DON'T MESS With THE ETS

Priorities for the upcoming
EU Emissions Trading System revision



CARBON MARKET WATCH

Table of Contents

Images credits :

Cover: Prokreacja / Getty Images

Javier Sepulveda Pascual, Frantzou Fleurine, Martin Adams, Marek Piwnicki, Maxim Hopman, Engin Akyurt, Patrick Hendry, Markus Wrinkler, Christian Lue, Ruben Hanssen, Aron Marinelli, Ben Allan, Chris Johnson, Slava Kompaniets, Mika Wegelius, Noa Van Ieperen, Ivana Cajina / Unsplash

Icons: The Noun Project

Introduction

The EU Emissions Trading System (EU ETS) is often referred to as a cornerstone of EU climate policy. Over the last 20 years by applying carbon pricing to greenhouse gas (GHG) pollution, it has helped cut emissions from power, industry, aviation and maritime sectors in half.

It promotes investment in a clean energy transition and emission reductions by making high-polluting business-as-usual practices more expensive, and also signposts a clear transition pathway for the EU to shift funding away from environmentally destructive activities to climate action, innovation and energy sector modernisation.

The ETS's carbon price signal provides a clear business case for a societal switch to renewable energy and electrification - critical for lowering energy prices, and granting the EU strategic autonomy by securing independence from volatile international fossil fuel markets. Dependence on fossil fuels has already caused two severe energy price crises since 2022. Even in 'normal' years, the EU and its member states spend nearly €400 billion on imported fossil fuels.

Revenues generated by the EU carbon market provide a constructive and collective (albeit time-bound) opportunity to invest in cleaning up our society, and to support people during the unquestionably necessary energy transition. That funding has already benefited innovative technologies and the people of Europe - but could still be targeted more effectively and with greater transparency.

The EU ETS is a leading international example of effective climate policy, with more and more carbon pricing schemes being proposed and developed globally. In 2025, the World Bank estimated that more than a quarter of global emissions are covered by carbon pricing, raising around €85 billion in revenues in 2024 (EU ETS alone raised €38.8 billion).

Complemented by the Carbon Border Adjustment Mechanism (CBAM) - the EU ETS is incentivising other jurisdictions to follow suit. Major EU trading partners (including China, South Korea, Japan, Turkey, Brazil) have already implemented, or are in the process of implementing, carbon pricing schemes. The EU is not going it alone, but it operates the world's most effective scheme and therefore acts as a leading example.

Any weakening of the EU ETS therefore risks not only upsetting the EU's decarbonisation efforts and disrupting the bloc's long-term industrial competitiveness, but would also signal to other countries that the EU is backsliding on its signature policy by blunting a highly effective climate tool.

The ETS is working, but as we will demonstrate, it remains far from perfect. It certainly isn't aligned with the 1.5°C goal of the Paris Agreement, is still structurally oversupplied, and is hampered by overgenerous subsidies such as the abundant free allocation of pollution permits that continue to undermine the investment incentive for zero-carbon solutions. Plus it still has a lot of work ahead of it, since in 2024, 82% of emissions from ETS installations were still from burning fossil fuels.

This position paper sets out Carbon Market Watch's priorities for improving the system's functioning and environmental delivery en route to the EU becoming climate neutral by 2050 (even though science informs us that a much shorter timeline must be followed to prevent serious climate breakdown).

Policymakers take note: there is widespread demand and an urgent need for strong and predictable carbon pricing in Europe. Each previous revision of the ETS has led to a stronger and more effective system - and there is a lot of space for improvements moving forward. Now is not the moment to backslide on the impressive regulatory achievement that is the ETS.

Stay the course.
Don't mess with the ETS.

Why do we need the EU ETS?

While quite a few reckless policymakers seem to view the issue as something that is out of fashion, there can be no doubting the evidence that the world is still facing an unprecedented and disastrous climate emergency.

The latest European State of the Climate report by the World Meteorological Organisation and Copernicus paints a very bleak picture. In 2025 heatwaves extended from the Arctic to the Mediterranean, while climate breakdown records were broken across the EU. Sea surface temperatures were the highest ever recorded, and never before have wildfires burnt through such a large area.

This crisis risks the lives and livelihoods of not only future generations, but also those currently living, as well as the survival of many other species we share this planet with. The EU ETS is first and foremost an instrument for 'cost-effective' emission reductions, by creating a carbon market that applies a monetary value to planet-warming greenhouse gases and uses generated revenues to fund climate action. In 2025 an International Court of Justice ruling determined that climate action is not just a moral imperative, but has become a significantly stronger legal responsibility too, outlining a clear obligation for all countries to address the climate breakdown.

Climate action can come with a cost (in this case for polluters), but climate inaction is far more costly for society. A recent peer-reviewed economic study confirms that the current trajectory of global warming will lead to a welfare loss of more than 30%, and a social cost of carbon of over $1200 per tonne: numbers that demonstrate that well-designed decarbonisation policies are smart economics. They are also cost-effective if the costs pollution incurs on society are properly accounted for.

And tackling the climate crisis has multiple other additional benefits, which outweigh the current narrow and short-sighted political focus on industrial competitiveness. The health benefits of climate action are proven. The World Health Organisation states the case clearly that "Health is the argument for climate action". It is little wonder that EU citizens demand more, not less, climate action.

The pushback against the ETS in early 2026 (e.g. the Antwerp call to Alden Biesen) was both misguided and overexaggerated. It also ignores that climate and industrial policymaking can and should go hand in hand. The EU ETS can both drive and support industrial decarbonisation, as well as assist industrial competitiveness and innovation. However, competitiveness is the banner used by those attacking the EU ETS and seeking to kill, pause or weaken it.

The carbon market is 'an ally, not an enemy, of industrial competitiveness' by making a business case for green production, setting a clear direction of travel for the EU economy, and mobilising revenues to invest in climate solutions. Epico reports that 90% of Europe's announced clean industrial projects are still awaiting final investment decisions 'making policy credibility and stability decisive'.

Climate policy is not the correct tool to address industrial competitiveness concerns. To fix a problem, you have to tackle the root causes. And the EU ETS is

neither the root cause of high energy prices nor the broad and multifaceted issues faced by EU industry. Rather, the ETS has been a cash cow for EU industry. Historic windfall profits persist for some companies (see section 2), and overall industry still received more direct support through the ETS than the effective price paid - even when discounting the over €30 billion in annual subsidies through free allocation.

Industry carbon costs vs. EU ETS support

Direct support is nearly 5× higher than net carbon costs (2021–2024).

Source: CMW own calculations based on E3G data.

The carbon price's contribution to electricity prices is marginal. In France (which has a low reliance on fossil fuels for electricity generation) it adds just 1-2% to electricity bills. To further undermine the negative narrative surrounding climate costs: polls released by Politico in April 2026 show that Europeans want more renewables, even if it costs more.

The real competitiveness and economic risk is for the EU to remain dependent on pricey and unpredictable fossil fuels that are prone to chaotic price swings and supply chain unpredictability, highlighted by the US and Israeli war on Iran - which fossil fuels companies are profiting from (up to the tune of €25 million per hour). In the first two months of the war, the EU has watched its fossil fuel bill rise by €24 billion - a complete waste of money that must hasten the bloc's loosening of its expensive fossil fuelled binds.

Climate policy (including carbon pricing) is therefore a solution to sustainable competitiveness concerns, rather than a problem.

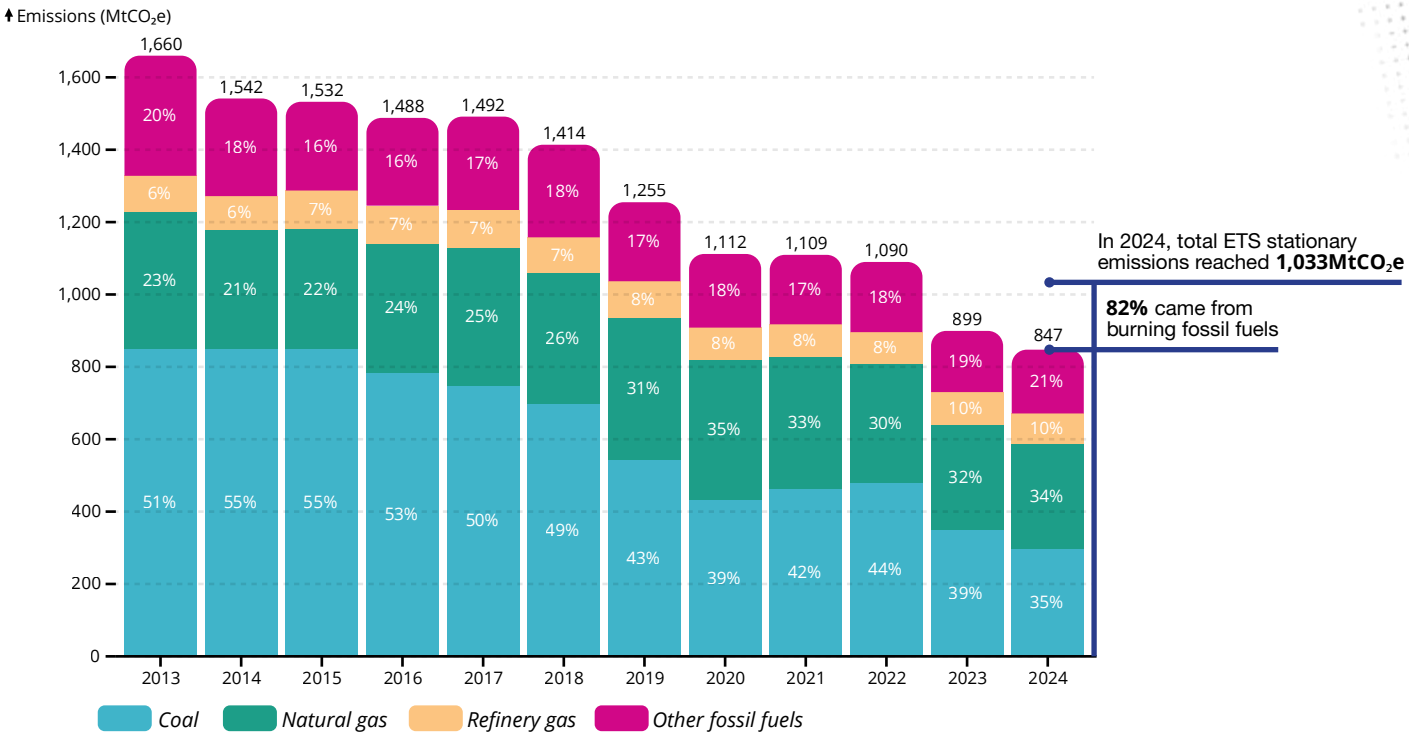
Moreover, those stressing competitiveness concerns include many energy intensive industries that call for increased subsidies and free allocation, and that are funneling billions of euros into shareholder payouts.

The three largest petrochemical companies returned over a whopping €65 billion to shareholders via share buybacks between 2022 and 2025. This trend goes well beyond the petrochemicals sector: between 2010 and 2023 European firms that should be investing in their energy transition (and therefore their competitiveness) generated €2.1 trillion in net profit and distributed €1.6 trillion to shareholders.

There are still a lot of emissions that the ETS can and must reduce. Aviation emissions from flights departing European airports increased by 8% between 2023 and 2024. The untargeted handouts of free allocation mean that industry emissions are stagnant by shielding those sectors from the carbon price, and continues to subsidise pollution. Moreover, the dirtiest fossil fuels are still alive and kicking in the EU today. While power sector emissions have decreased rapidly over the past two decades, it still emitted 250 million tonnes of CO_2 from coal in 2025, and in 2024 a staggering 35.1% of all combustion emissions in the ETS were from hard coal and lignite. Burning fossil fuels combustion still makes up for 82% of EU ETS stationary emissions, a number that must decrease to zero.

EU ETS emissions from fossil fuel combustion

82% of stationary emissions in 2024, with coal accounting for 35%.



Source: CMW own calculations based on European Commission data.

And of course, the EU ETS is still far from being equitable. The vast majority of industrial emissions are still not paid for by their emitters. The foreseen phase-out of free allowances should ensure Europe's largest polluters finally pay, but many sectors could still receive benefits beyond 2030 without any strings attached. That phase-out trajectory is critical to address industrial emitters, but vested interests are lobbying heavily against it.

The polluter pays principle is central to the EU ETS. Policymakers must remember that the price of CO_2 is not only an indication of the cost of emission reductions. Carbon pricing also carries an important distributional value, ensuring the external costs CO_2 are internalised (at least partially) by those responsible for emitting it. On the back of this, significant revenues are being raised to enable governments to support citizens, communities and industries during the climate transition of the European economy.

Uphold the principles of the EU's flagship climate policy

For the past two decades the Emissions Trading System has been a central component of the EU's climate action, halving emissions from the bloc's high polluting power generation and heavy industry sectors. What's more, this cap and trade system has uncapped potential in achieving even more. Key principles have underpinned historic success, and need to be defended moving forward.

The Polluter pays principle is enshrined in the Treaty on the functioning of the EU (TFEU; article 191) and is the legal basis of the EU ETS. However, there is still plenty of pollution that is not being paid for by the covered sectors.

Within the ETS the vast amount of free allocation to industrial emitters undermines this principle (as highlighted by the EU Court of Auditors). Since 2021 over 2.6 billion free allowances have been handed out for free, valued at a whopping €170 billion (of which nearly 500 million allowances just in 2024, €32 billion at 2024 average EUA prices). These free allowances are a massive subsidy for pollution that must be urgently addressed.

There's also a lot of room for expanding the ETS (and therefore the polluter pays principle). For example, the ETS should be expanded to include waste incineration and a greater share of aviation and maritime emissions. More emissions priced means more momentum towards decarbonisation, and also more revenues that can be invested in supporting people and businesses through the transition.

The TFEU also highlights the need for preventive action and rectifying environmental damage at source. That logically means that emission reductions must take priority ahead of - and not be slowed down by - other potential climate measures, (such as carbon removals or international carbon credits). Combined with the precautionary principle - requiring EU policymakers to err on the side of caution - the primary and only focus of the EU ETS should remain to deliver domestic emission reductions.

The ETS must also remain climate target-aligned. Any weakening of the ETS or permitting of extra emissions beyond the current carbon budget has to be compensated in other sectors to ensure the EU is on track to achieve its 2040 and 2050 climate targets. Policymakers should not risk dismantling decades of work into establishing a meaningful carbon price signal and building international leadership on climate policy.

Finally, the principle of historic responsibility has not fully received the attention it warrants. Europe is a rich region, accumulating its wealth through generations of industrial expansion. However, this came at a substantial cost to the climate over centuries. The EU has played a large role in causing the climate crisis and is directly responsible for 12% of global cumulative emissions. As a wealthy, developed continent with strong institutions, highly-skilled labour and engaged civil society, the EU is uniquely well placed to do something about the problems it caused in the past. EU policymakers mustn't overlook their historic responsibility, while considering how to to tackle their challenges related to executing a just climate transition, including supporting developing countries.

How to keep the ETS on track

DON'T MESS With THE ETS

1. Want a new cap? Make it carbon budget neutral
The ETS doesn't need any additional supply before 2035

2. Freebies have prevented investments: eliminate them once and for all
Carbon leakage protection has been a wasteful failure – and must be phased out. Make any residual freebies conditional on climate investments

3. Use revenues wisely: kick out fossil fuels subsidies
Too many revenues are being wasted, and transparency is lacking

4. Predictability is good for business, allow the MSR to do its job
The ETS will be oversupplied for years to come – let the MSR cook

5. An absolute no to offsetting
Learn from past mistakes – don't reintroduce offsets or international credits

6. Keep removals out of the system
Integration of carbon dioxide removals is a slippery slope best avoided

7. Cover all international flights and private aviation, plus remove biofuel handouts
Too much of aviation's pollution isn't priced

8. Cover smaller vessels and all international voyages
Shipping sector should pay more for its pollution

9. Null and void the zero-rating of biomass
It sounds good on paper, but in the real world it drives deforestation

10. Leave the ETS2 alone – for once
Stop delaying and diluting ETS2, leave it off the chopping block.

1 Want a new cap? Make it budget neutral

The ETS doesn't need any additional supply before 2035

To ensure the ETS stays the course in supporting a domestic net-90% emissions reduction by 2040 target and climate neutrality by 2050 - enshrined in EU climate law - lawmakers must carefully consider how best to approach its three fundamental and functional levers:

1. the cap on annual emissions, that cannot be breached
2. the Linear Reduction Factor (LRF) which forces the cap down year after year, and ensures increasing scarcity of emission allowances over time
3. The Market Stability Reserve (MSR) that syphons oversupply out of the market, and that has proven successful in guiding the ETS back on track after a decade of low prices and low confidence in the system.

These three levers have a combined impact on the climate performance of the ETS and define the available emission space for the sectors covered towards climate neutrality. They are the core of the effectiveness of the ETS, and provide the long-term predictability that in turn creates a business case for decarbonisation.

The three levers are working as they have been designed. Any changes to this triumvirate risks undermining the credibility and predictability of the entire system, and should not lead to increasing the overall carbon pollution space. Severe alterations could weaken the system's ambition and price signal, or even lead to the perception that the ETS has failed, and that the EU is backtracking on its climate targets. Moreover, weakening any of these three levers would only serve the short-sighted interests of heavy polluters that benefit from a business-as-usual approach.

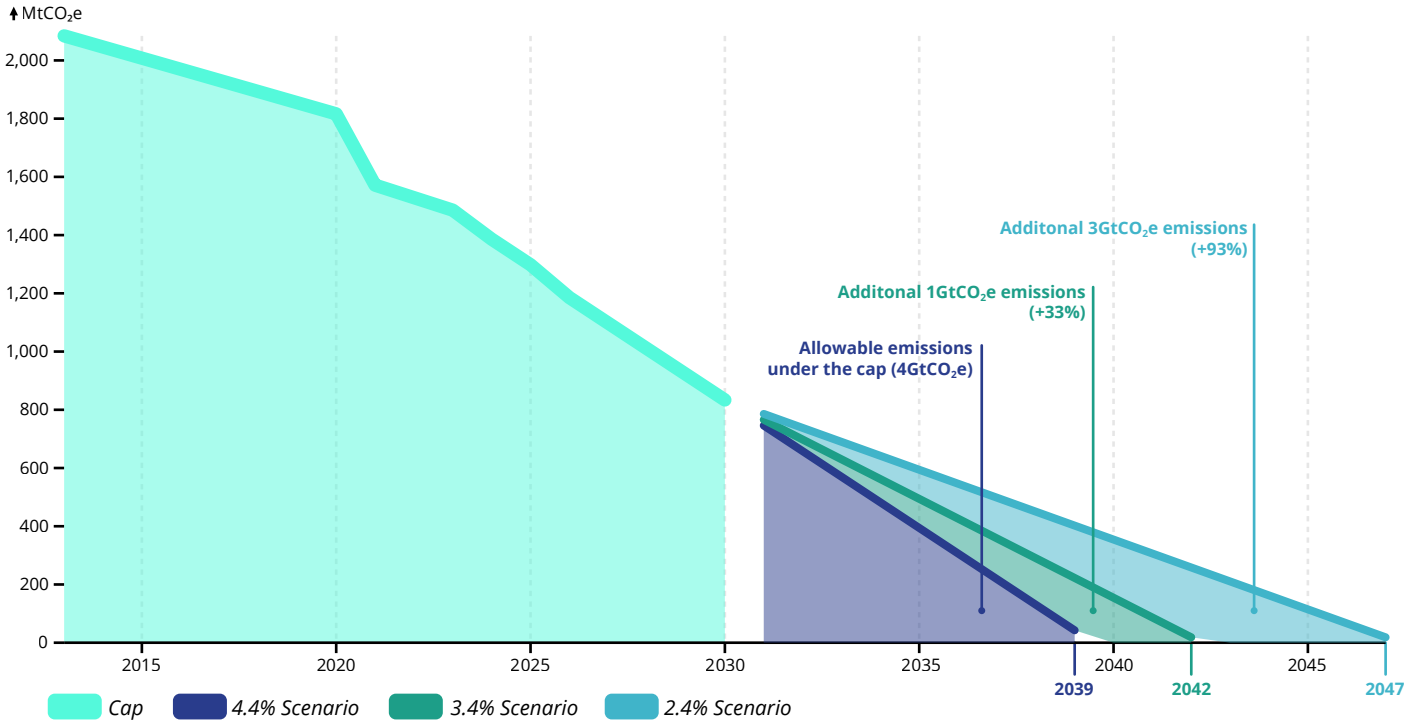
In the short term there is no need to tinker with the cap, Market Stability Reserve (MSR) or Linear Reduction Factor (LRF). Under several decarbonisation scenarios, the EU ETS will remain oversupplied until 2036.

As there is no misalignment in the supply and demand of allowances until 2035, the emission reduction pathway of the ETS1 should remain untouched until this point to drive cost effective emissions reductions and maintain revenue streams for member states to fund decarbonisation efforts. Beyond 2035, a higher supply of allowances in the ETS has to be accompanied by a greater effort to reduce emissions in non-ETS sectors, especially from agriculture, otherwise climate targets will become unattainable.

Minor alterations to the LRF have significant impacts on the quantity of emission allowances available over time. Reducing the LRF to 3.4% would delay zero emissions until 2043, effectively allowing an additional one billion tonnes of greenhouse gas emissions into the atmosphere. A further dilution to 2.4% would push near-zero emissions out to 2048, resulting in roughly three billion additional emissions on top of the cap as foreseen in the current 4.4% scenario.

EU ETS cap trajectory and post-2030 scenarios

Current cap trend to 2030 and projections from 2031 under alternative LRFs (4.4%, 3.4%, 2.4%).



Source: CMW own calculations based on European Commission data.

However, some emissions will continue under the ETS after 2035, or even after 2040. Post-2036 the LRF and cap might need adjustments to allow for very limited, last to abate industrial process-related emissions to remain within the scope of the system.

This year's European Commission revision proposal will need to set out a vision of which emissions from which sectors would remain permissible from a societal perspective. However, using the blunt 'highest marginal abatement' rationale to let the market decide which emissions will be residual in 2040 is not the right way forward. For example, aviation emissions (including private jets) might be challenging to abate in the short-to-mid-term, however they are largely unnecessary for our society to function and flourish.

Three conditions must be upheld if the ETS is to change its post-2036 trajectory:

1. Residual emissions must be quantified as those left over after all abatement options have been used. The goal must be to overcome short-term economic barriers to abatement, either through a sufficiently high rise of the carbon price, or through a combination of carbon pricing with targeted, yet limited, support.

   Residual emissions must exclude any fossil fuel emissions, or process emissions that can be captured and stored. Fossil fuels alone currently account for over 80% of stationary ETS emissions (power and industry), but even after discounting those fossil fuels, 2024 data shows a remaining total of 186 million tCO_2 non-fossil emissions (not counting international transport), of which a significant proportion are capturable process emissions. Additionally, the classification of emissions as 'residual' must depend on what is considered to be 'desirable' or too important for society to give up despite its climate impacts, such as a limited amount of long-distance air travel or essential and specialised industrial products where no alternatives exist.

2. A residual emissions cap should still decrease over time, and must become a component of a synchronised economy-wide net-negative climate target, to maintain pressure on eliminating the last remaining emissions. Residual emissions are dynamic, not static, and depend on technologies, consumption patterns and political will.

3. Any loosening of the LRF and MSR to allow for emissions from stationary installations post-2039 must be approached in a carbon budget neutral way - a relaxation of the LRF towards the 2040s can only be conceded if coupled with a more demanding LRF or MSR intakes in the short term.

Extending the life of the ETS is not a goal in itself, but as an instrument, the carbon market can still be effective once the expected post-2036 'liquidity crunch' hits. That effectiveness will hinge on the strength of EU and national level complementary and sectoral policies implemented by that time to address the last few remaining emissions.

So-called 'non-permanent' carbon capture and utilisation (CCU) should not be considered an emission abatement for ETS emissions, or it risks providing a carbon accounting loophole where emissions leave the pricing regime of the ETS, yet still end up in the atmosphere.

2 Freebies have prevented investments: eliminate them once and for all

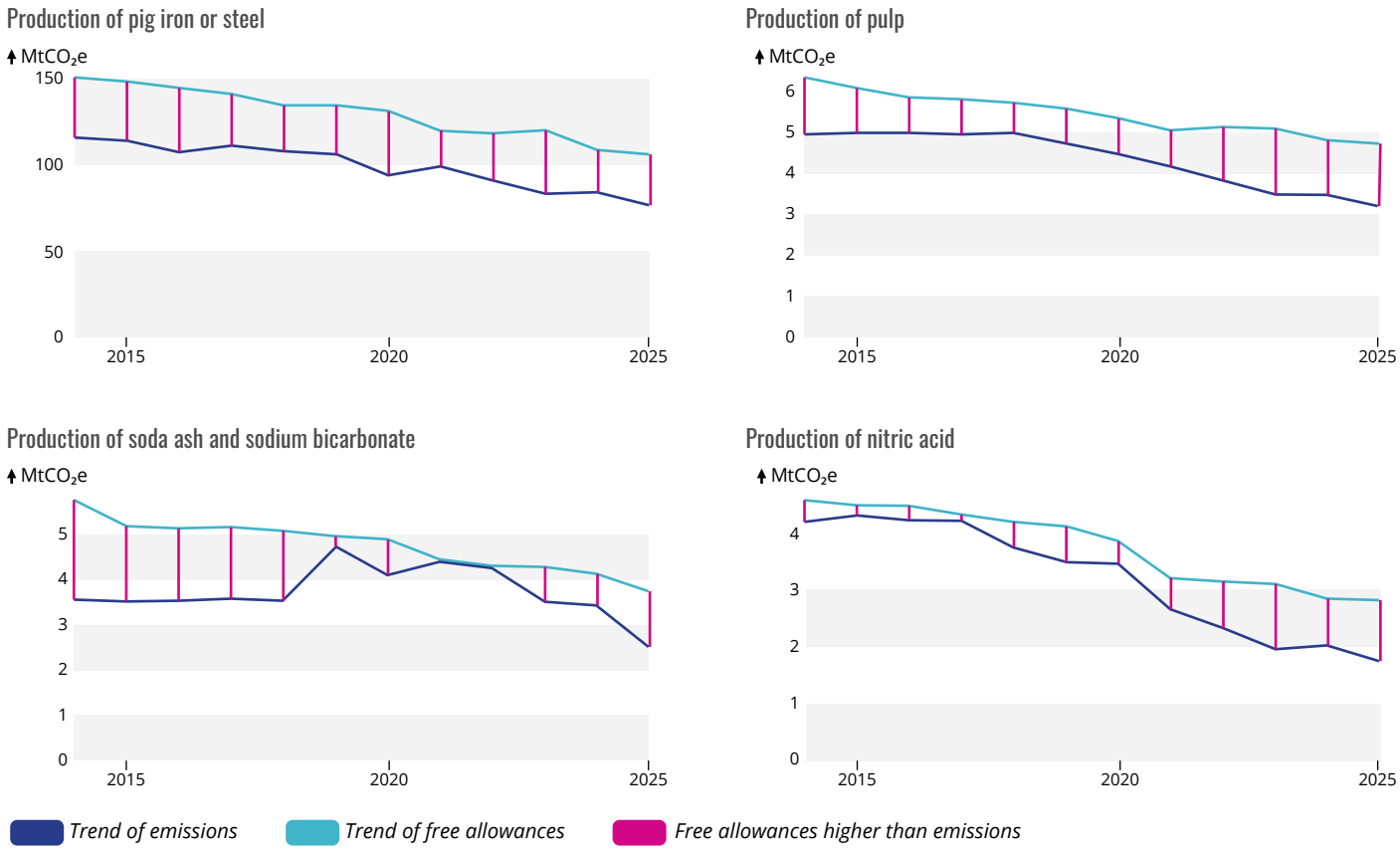
Carbon leakage protection has been a wasteful failure - and must be phased out. Make any residual freebies conditional on climate investments

Currently not all emissions are treated equally by the EU carbon market. Between 2008 and 2021, about €200 billion worth of EUAs were handed out at no cost to heavy industry: these allowances were surrendered, banked, or even sold for a profit. In 2024 alone, nearly 500 million allowances were still handed out for free at a value of over €32 billion (when applying the average market price for 2024: €64.74/tonne of CO_2). These are foregone revenues that member states won't be able to spend on climate action, on supporting vulnerable people, or on the transformation of the European economy.

Free allowances were originally imagined as a transitional mechanism, but two decades after the scheme's launch these freebies remain in high circulation. The vested financial interest they have created has led to the measure being extended time and time again. Despite auctioning being foreseen as the default rule since 2013, for industry the purchase of EUAs remains the exception: more than 90% of industrial emissions continue to be covered by free emission allowances. Since 2021 a whopping 97% of total EU energy intensive industrial climate pollution came at no cost.

Emissions and free allocation across EU ETS activity types

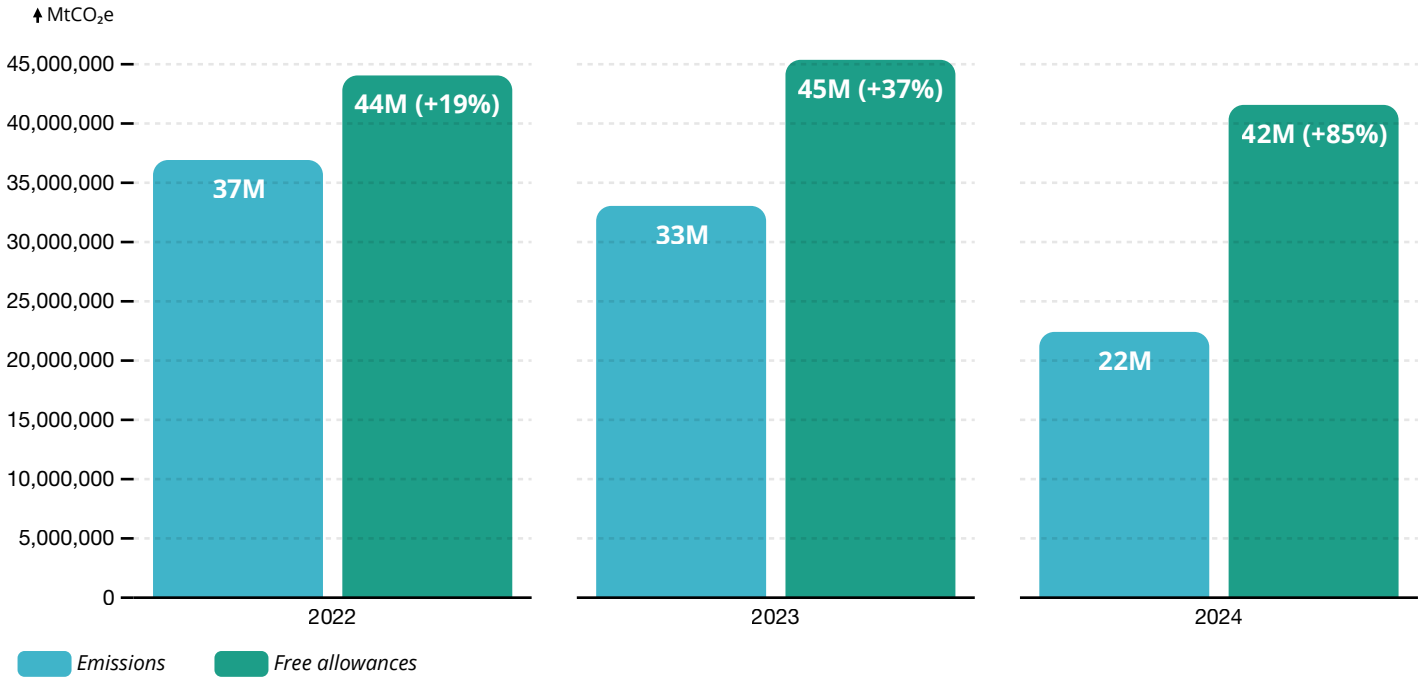
Focus on activity types with structural overallocation.



Source: CMW own calculations based on European Commission data.

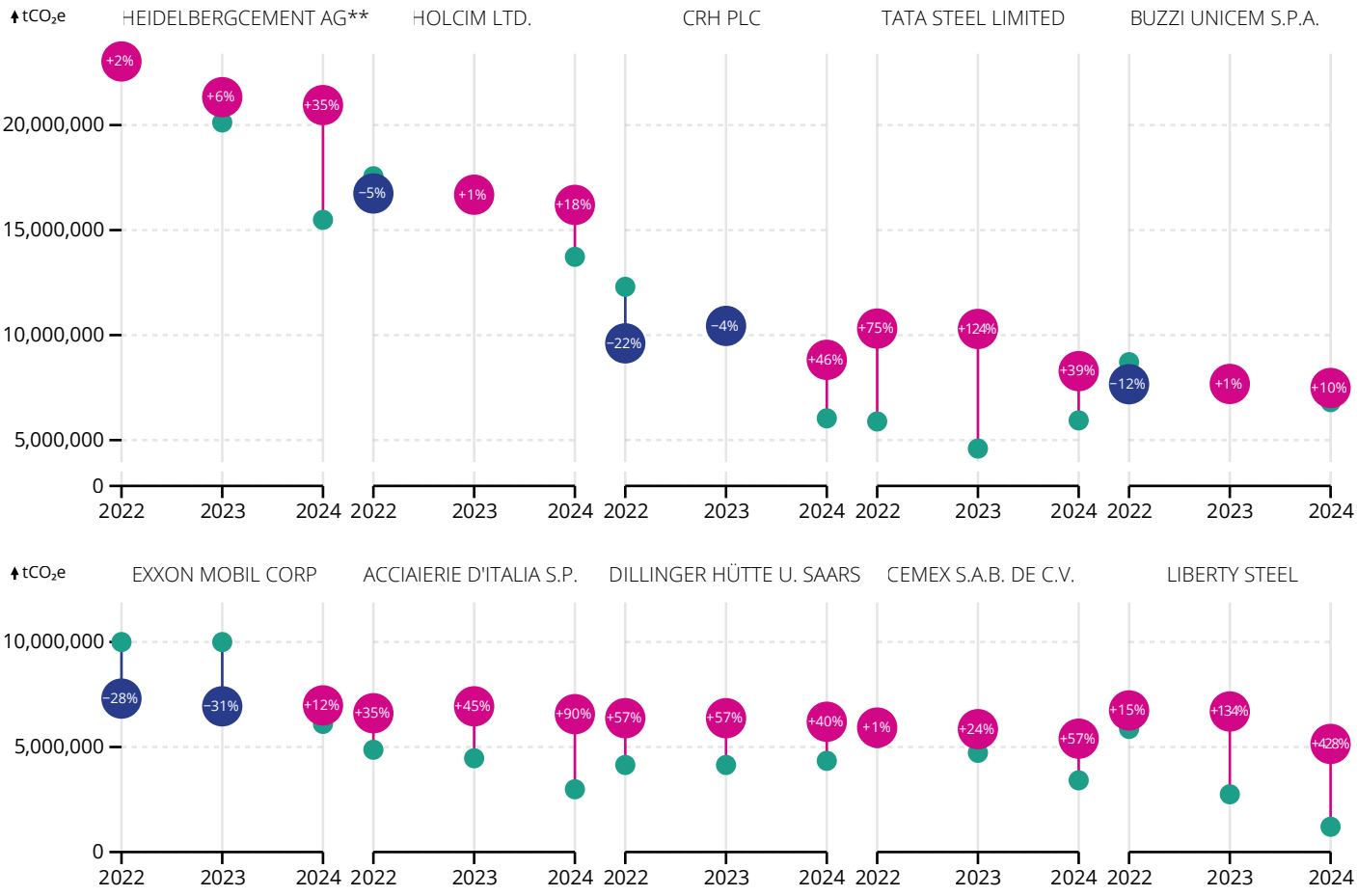
ArcelorMittal: persistent overallocation of free allowances

In 2024, 22MtCO₂e emitted vs. 42 million free allowances received (+85%); overallocation observed consistently from 2022 to 2024



Free allowances vs. emissions: Top 10 over-allocated companies (Excl. #1)

A three-year comparison (2022-2024) of companies ranked 2–11 receiving the most free allowances highlights cases where allocation exceeded actual emissions in 2024.



Source: CMW own calculations based on European Commission data.

The Court of Auditors has confirmed that free allocation hampers decarbonisation efforts. In addition, they concluded that free allocation to the industrial and aviation sectors was not linked to a risk of carbon leakage, as their ability to pass through direct ETS costs to end consumers isn't sufficiently taken into account. This oversight has real consequences, as evidence shows that energy-intensive companies profit massively by charging their consumers the market value of the freely allocated allowances. The free allocation has led to companies profiting from the EU carbon market by up to 50 billion euros between 2008-2019.

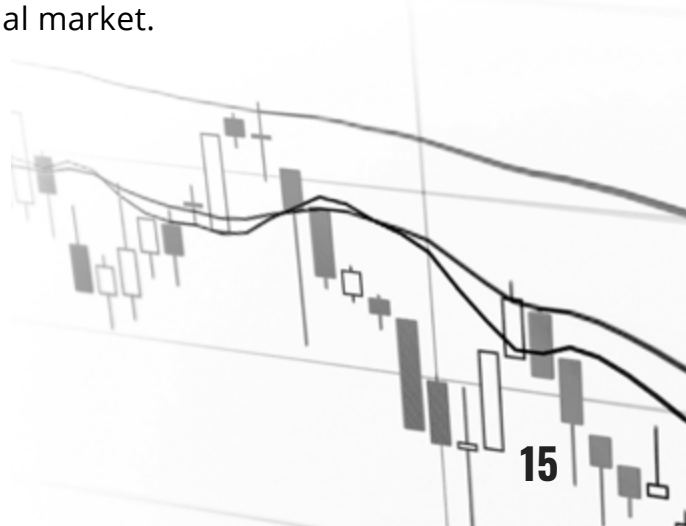
Free allocation to industry needs to stop, and the current phase-out trajectory for CBAM products should be respected. Additionally, non-CBAM ETS sectors that the European Commission deems at risk of carbon leakage (with refineries and chemical products the largest polluters of that group) should be covered by CBAM. Freebies awarded to them must be phased out fully by 2034 at the latest, in line with the planned phase-out of free allocation for other sectors. Even in this phase-out scenario, over 2.3 billion additional allowances would still be handed out for free to all sectors concerned from now to 2034 - an additional €190 to €220 billion in lost revenues (assuming an average carbon price between €85/tCO_2 and €95/tCO_2 between 2026-2034).

As long as free allowances remain available to industrial sectors, their allocation must depend on the strict condition that they are linked to investments into real, meaningful and transformative emission-reducing actions and processes. Free pollution subsidies must only be disbursed to entities that can prove additional decarbonisation investments of similar values, similar to what has been proposed in the Temporary Decarbonisation Fund. Each installation must draft a Climate Neutrality Plan (as is already the case for the most polluting installations under the ETS), and should only retain free allowances if the yearly investments and decarbonisation milestones set in the plans are achieved. If the promised investments are neither proven nor implemented, recovery measures must be triggered.

Tellingly, industry is opposed to attaching conditions to free allocation, while also stating that handouts are necessary for them to make investments. These arguments have been the same for over ten years, yet the necessary decarbonisation investments still have not materialised. Policymakers must enforce investment conditions to ensure any residual free allocation has a climate impact, and doesn't lead to more share buybacks.

If the phantom of carbon leakage keeps returning, then it must be exorcised by applying the same carbon price paid domestically to imported products through the Carbon Border Adjustment Mechanism (CBAM). The CBAM must be allowed to run its course and be geared up over time.

Claims that free allocation can only be phased out if CBAM is proven effective ignore that carbon leakage risks are yet to be proven - while it is certain that free allocation is slowing down decarbonisation. Carbon leakage protection measures should not shelter laggards and fossil addicted companies. Neither should it distort the EU's internal market.



3 Use revenues wisely: kick out fossil fuels subsidies

Too many revenues are being wasted, and transparency is lacking.

Between 2026 and 2030, the EU ETS is expected to raise between €120 and 150 billion (assuming an EUA price range of €75 to €95) in auctioning revenues for member states. On top of that, ETS revenues feeding the Innovation Fund and Modernisation Fund may cumulatively increase climate action funding to as much as €93 billion.

These revenues need to be spent urgently and with consideration of how they will deliver the most direct emission reductions possible, support people who need it most during the energy transition and to prepare against the impacts of the climate crisis itself.

Since the last ETS review, EU member states are obliged to spend all their auctioning revenues on climate-related purposes. However, the list of climate-related funding priorities for member states is outdated and needs a fundamental overhaul. Major untapped opportunities lie in the domains of reinforcing resilience and adaptation, eradicating energy poverty, developing clean transport and energy-efficient housing, reskilling workers affected by the transformation of the economy, protecting and improving biodiversity, and promoting sustainable agriculture and forestry practices.

At the same time, as highlighted by the outcomes of the UNFCCC negotiations at COP29, the EU's international climate finance commitments must be stepped up to support the needs of the most vulnerable developing countries. All these priorities (and more) require funding, but every Euro of ETS revenues can only be spent once, while revenues will peak and decline throughout the next trading phase.

By encouraging member states to prioritise revenues in terms of emissions avoided, the EU can adopt a "people first" approach to fund (including with ETS revenues) projects and policies that would directly benefit the lives of communities in the EU and internationally.

Industry groups are claiming these revenues to cover their own decarbonisation costs, and to receive extra subsidies (such as compensating for electricity use, even when fossil fuel-based, through the indirect cost compensation mechanism), with little consideration for broader societal needs. However, the climate impacts from industrial emissions burden the whole of society, so ETS cannot be a mere 'cashback' tool for industry.

The “indirect cost compensation” (ICC) is a waste of revenues with little decarbonisation efforts in return. In 2024, over €5.5 billion was spent by the member states (23% of member state ETS revenues!) to overgenerously subsidise companies for the use of fossil-based electricity. Electrification should be pursued through decarbonisation investment incentives (as those outlined above), and support the efforts of first movers and early investors. As fossil fuel subsidies are an unacceptable burden to public budgets and society, it is time to throw ICC in the rubbish bin. And any remaining subsidies should be covered by the same investment, social and climate conditions as outlined above for free allocation. The existing ICC conditions are toothless, and easy boxes to tick without taking action in exchange.

Industrial transformation needs investment from both private and public sources to be achieved. Good examples are the establishment of the Industrial Decarbonisation Bank, the financing tool announced by the European Commission in February 2025 to expand and complement the Innovation Fund, but corporate polluters must not be the only beneficiaries of ETS revenues.

4 Predictability is good for business, keep the MSR doing its job

The ETS will be oversupplied for years to come - let the MSR cook

The Market Stability Reserve (MSR) is one of the most powerful mechanisms in-built to the ETS. In its current set-up, it has not only resulted in measurable climate benefits but has also put an end to a prolonged era of collapsed confidence in the ETS and carbon prices. Since its establishment, the MSR has successfully invalidated 3.4 billion ETS allowances, preventing the equivalent number of tonnes of CO_2 from entering the atmosphere.

The stability of and predictability of the ETS is part of the solution, not the problem. The MSR mechanism ensures that auction revenue is reliably distributed to member states to support climate innovation and clean production today.

The April MSR1 proposal should be rejected. The proposed deletion of the invalidation clause is a substantial weakening and undermines the effective functioning of the EU ETS. Rushing through such an ill-conceived and drastic market intervention would be irresponsible. In addition, it would be highly counterproductive in the short term.. The ETS is still plagued - and could be up until 2036 - with structural oversupply caused by an overabundance of emission allowances that outstrips demand. In 2024 supply was 276 million tonnes higher than demand due to an overgenerous cap.

The MSR is necessary and effective for addressing persistent oversupply, upholding the carbon price signal, and delivering long-lasting climate benefits. Over the past three years, about 300 million allowances have been invalidated annually from the MSR, and left to its own devices, it will continue to remove excess allowances from the market for years to come.

Oversupply may also increase because of demand decreasing more than the models suggest. This could be due to complementary policies such as planned coal phase-outs, and to international and/or economic shocks. The MSR was initially designed to deal with shocks and historic oversupply, and geopolitical crises like the fossil fuel price hikes caused by the war on Iran show unexpected shocks remain a real risk for the ETS.

Diluting the MSR now risks fundamentally upsetting the market's supply-and-demand balance. This will unduly inflate greenhouse gas emissions after 2030 (up to 900 million extra tonnes of CO_2!), hindering the achievement of the EU's 2040 climate target. Moreover, it risks weakening the long-term carbon price signal, undermining the business case for the deep decarbonisation investments that must be undertaken already today.

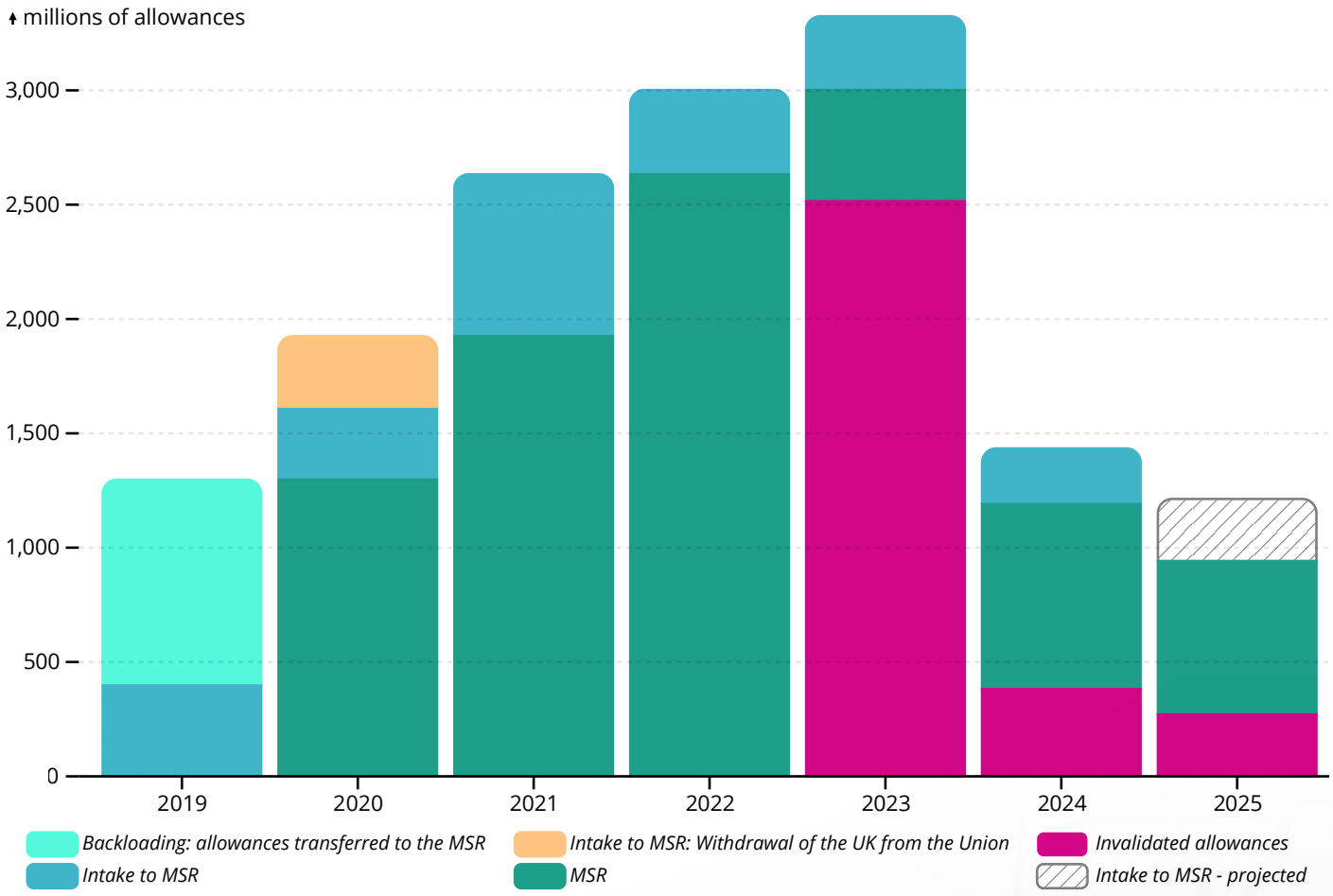
After 2035 the market might become short, meaning the MSR will start releasing 100 million allowances per year. There is no need to top up the emission allowance budget, and premature ad-hoc measures to weaken the MSR should be avoided to ensure that as many emissions as possible can be effectively mitigated. The MSR's functioning should be left untouched till the second half of the 2030's.

Ideas to replenish the MSR with international credits are equally shortsighted. Those credits (which we will cover in more depth later in this paper) will not have the same climate value as an EUA and should never enter the system again, including through the MSR1 as a backdoor.

Price containment must not come at the price of the environmental integrity of the system. The MSR cancellation mechanism must be preserved, while the current ETS (Article 29a) already addresses price surging concerns. Flooding the market with allowances to address price increases (e.g. by frontloading auctions) has already proven to destabilise the market and create discontent among investors. Each allowance released back into the market represents more CO_2 allowed to enter the atmosphere, each intervention to drive prices down punishes first movers and innovators.

Market Stability Reserve (MSR) in action

3.4 billion ETS allowances invalidated, tightening the EU ETS cap.



Source: CMW own calculations based on European Commission data.

5 An absolute no to offsets

Learn from past mistakes - don't reintroduce offsets or international credits

During discussions to set the EU's 2040 climate target, the spectre of international credits re-entering the EU's carbon market was raised. Turning the ETS into an offsetting mechanism would radically change its nature, and mean the EU will repeat a significant error from its past.

It would dilute the system's purpose and credibility by making it possible for industries to perform accounting tricks and outsource climate action at a cheaper price to somewhere else in the world. The ETS would reach its targets on paper, but not in the real world as selecting cheaper alternatives (at least in the short term, and discounting the impacts of the climate crisis itself) does nothing to tackle pollution at source and generate funds to invest in the clean industries of tomorrow.

During phase 3 (2013-2020) over 1.6 billion international credits entered the ETS and wrecked the price signal, delaying emission reductions and completely undermining the effectiveness and credibility of the ETS as a climate action mechanism for a decade. The use of Kyoto credits hamstrung the functioning of the EU ETS by inflating the oversupply of emission allowances, thereby lowering the incentive for European industry to decarbonise. In addition, confidence in the climate benefits of these cheap credits plummeted due to their lack of environmental integrity and the harm caused by some of these projects to local and indigenous communities. The next generation of credits from Article 6.4 projects risk repeating or even escalating that harm, as guidance on protecting and upholding the rights of local communities and indigenous peoples falls structurally short.

Recent analysis shows that there is no reason to believe that bringing international credits from the Article 6 system under the Paris Agreement into the EU ETS now would lead to significantly different results.

Policymakers must not forget their (very recent) history - and avoid stumbling into this mistake again with their eyes wide open. Any integration of international credits risks severely depriving member states and EU-level funding mechanisms of revenues, while it could subsidise the industrial third-country competitors of EU installations.

Offsetting has absolutely no place in a credible EU ETS. There can be no ifs, buts or maybes: do not integrate offsets (such as international credits) into the EU ETS.

6 Keep removals out of the system

Integration of carbon dioxide removals is a slippery slope best avoided

The International Panel on Climate Change (IPCC) has determined that for the planet to reach net-zero, permanent carbon dioxide removals (CDR) will be required. In 2050, all remaining emissions will have to be counterbalanced by permanent removals for the EU to be truly climate neutral. However, given the limited potential for - and high financial and environmental cost of - many technological solutions, reliance on CDR must be restricted to a strict minimum. Removals can only play a significant role in addressing the climate crisis if emissions are pushed down far enough.

The European Commission is obliged to look into how removals can be covered by emission trading, but note that the mandate from the ETS Directive does not refer directly to the EU ETS instrument itself. Carbon Market Watch considers that there is a role for the EU ETS to support the development of the EU removals sector in the short term through the revenues it generates, but the suggestion to integrate removals directly into the ETS must be considered an absolute non-starter. Addressing the climate crisis requires both emission reductions (primarily) and removals (secondary), not either-or. The logic of zero-sum offsetting must be rejected.

The ETS must function first and foremost as an effective decarbonisation mechanism: there are still many emissions left to abate (for example, the EU power sector alone emitted 250 million tonnes of CO_2 from coal in 2025). We are nowhere near 'residual emissions' level and therefore still have a lot of work to do to reduce our emissions.

Burdening the ETS with the extra duty of directly supporting removals will undermine its effectiveness as a decarbonisation tool. If CDR and EUAs are deemed equivalent in the system, polluters will be able to choose between addressing their emissions or buying removal units, transforming the ETS - once again - into an offsetting mechanism.

This risk for mitigation deterrence was foreseen by the co-legislators during the previous ETS revision - they added a guiding principle to Article 30(5)a: "ensure that [...] removals do not offset necessary emission reductions". This safeguard must be the guiding principle of any interaction between removals and the ETS, and the threat of mitigation deterrence must be taken very seriously, especially in the short term.

Second, permanent removals involving geologic storage are too expensive to be supported through direct integration into the EU ETS. The price differential will remain significant in the short-to-medium term (Biogenic Carbon Capture and Storage - BioCCS: €150-200 and DACCS €500-1000 per tonne, vs the EUA price of €75 in early 2026). Costs for Direct Air Carbon Capture and Storage (DACCS) are estimated to drop to around €200 - 500 per tonne by 2050. On the other hand, the carbon price has fluctuated around €75 over the first months of 2026: a fraction of the cost of CDR. This price differential would need to be bridged before any removals can feasibly enter the carbon market.

Additional policies and support mechanisms will be needed to mature and scale this sector in any case, and are better suited to do so. On the one hand, by the time that the price differential could disappear, the ETS will be too small to provide a strong demand signal for CDR. On the other hand, emissions outside ETS sectors will also need to be compensated.

Third, the quality of the removals risks being too low to compensate for an emission under the ETS. The Carbon Removal and Carbon Farming certification framework's permanent removals methodologies are faulty to the core. The CRCF risks mislabeling activities that increase global emissions as removals, which is an unacceptable risk for the integrity of the EU ETS.

Fourth, while limits on quality and/or quantity could be set, and intermediary institutions established, any direct integration of removals would make the EU ETS an offsetting scheme again: damaging its ability to reduce emissions, potentially beyond repair.

Finally, some stakeholders (even unapologetically) want to throw carbon removals into the ETS as a means to drive the carbon price down. Permanent removals won't do that, but their integration opens the door to cheaper and lower quality offsets down the road - biochar or options with high risks of reversals such as forestry and soil carbon. This may well be the end goal of some CDR pushers, and should concern everyone who champions the ETS as an effective climate tool.

Direct integration of CDR in the ETS is either a dead end, or the start of a slippery slope. However, there is an argument to be made for using ETS revenues to invest in research and development - or even fund - CDR projects. Permanent removals can be supported by options other than the carbon market, but these risk being ignored if the unconvincing and potentially destructive path of integration into the ETS is pursued.

7 Cover all international flights and private aviation, plus remove biofuel handouts

Too much of aviation's pollution isn't priced

Not only do aviation emissions contribute significantly to climate pollution, they are fundamentally unfair too as a small, wealthy minority drives the majority of emissions. Just 1% of people are responsible for over half of global aviation emissions.

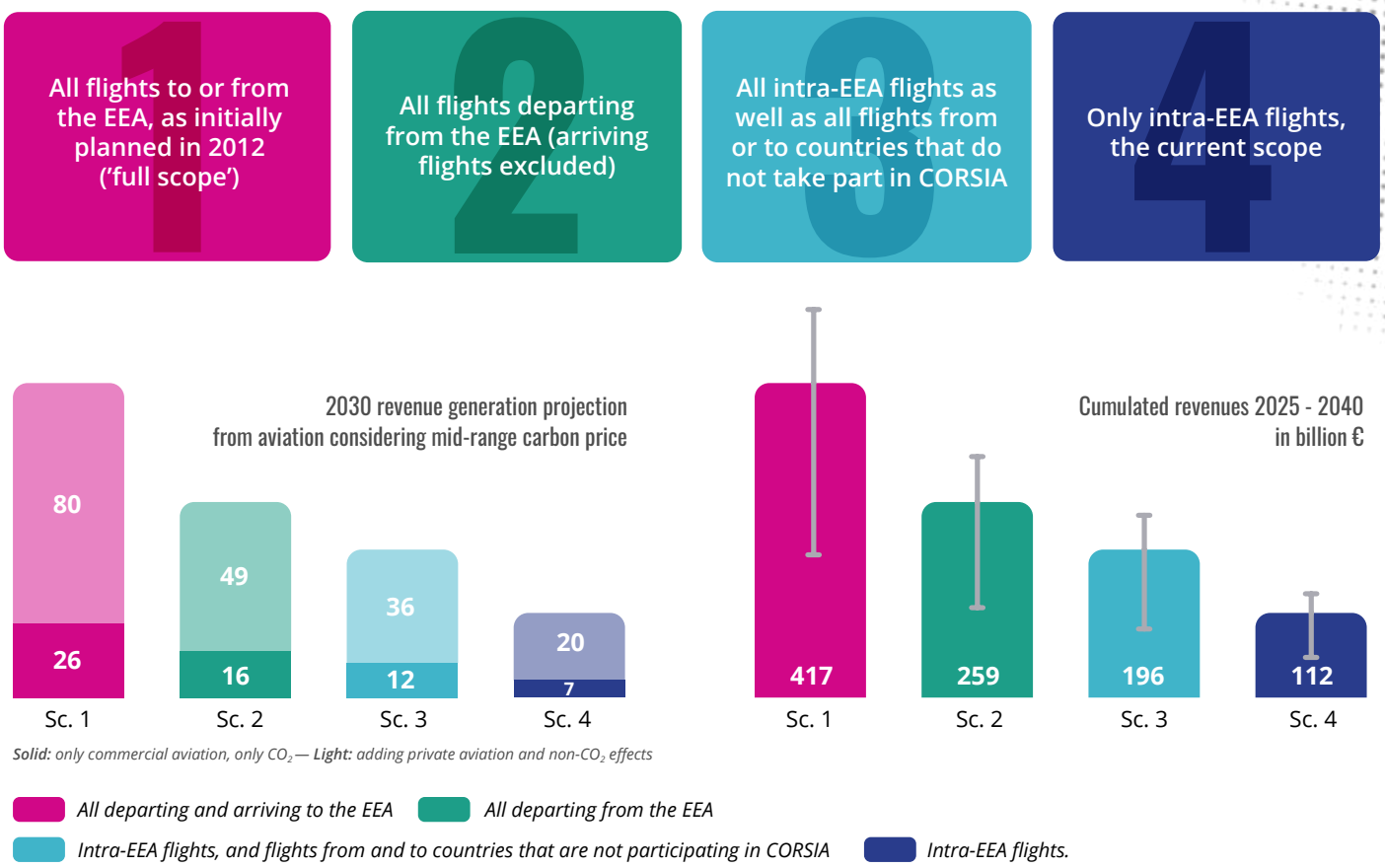
Existing rules fail to address aviation emissions fairly, as the most polluting journeys (extra-EEA flights and private jets) do not cover their dues. ETS covers only around 15% of the sector's true climate impact, limited to CO_2 from flights within the EEA, excluding all extra-EEA flights and non-CO_2 effects (such as contrails).

This must change. The EU cannot continue to treat aviation as an exception while holding other high-polluting sectors to account. The 2012 "stop-the-clock" exemption – introduced under pressure from US lobbying – cost €26 billion in lost revenues between 2012 and 2023 and left emissions equivalent to Greece's total greenhouse gas output (1.1 billion tonnes of CO_2) unpriced.

Extending the scope of the aviation ETS to cover all flights departing and arriving from the EEA – as originally planned – would generate an extra €19 billion annually by 2030 (assuming an average EUA price of €122). However, even this would not fully ensure that the aviation sector pays for all its emissions. Achieving that would require covering all private jet flights and pricing them with a price multiplier of four (x4), reflecting their higher fuel consumption per hour and per seat, as well as pricing non-CO_2 effects. This would increase the total aviation revenues to €106 billion per year by 2030 (based on an average EUA price of 122€) while finally aligning the sector with its true climate cost.

Projected total ETS aviation revenues in 2030

under four scenarios (€122/tCO$_2$) (billion €).



Source: Céleste Grillet, et al., International aviation: Will the EU restart the clock?, Carbone 4, Carbon Market Watch, 2025.

In this context, there is no need to top up the aviation industry with free allowances to cover any carbon leakage risks which are minimal – affecting at most 3% of aviation emissions under Fit for 55 – and concentrated on a few long-haul routes, for example to South East Asia via nearby hubs like Istanbul. If significant leakage risks are found through careful analysis, they should never be addressed through free allocations, whether general or conditional (e.g., so-called 'SAF allowances'). Instead, any mitigation measures should be limited to higher ETS pricing on specific extra-EEA routes that are at genuine risk, to correct the cost-advantage of transferring through non-EEA airports.

Overall, demand is driven far more by airline strategies and travel trends than by carbon pricing. Moreover, price changes affect various passenger groups differently. Long-haul and business passengers, private jet users, and frequent flyers tend to be the least sensitive to price increases, despite being the most emissions-intensive travellers (and clearly having deeper pockets).

International aviation policy is also not a reason to keep the clock stopped. The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) was supposed to address emissions from international flights, including those to and from Europe. But it's clear the scheme is deeply flawed, suffering from limited emission coverage, patchy enforcement, and reliance on low-quality offsets instead of real emission cuts.

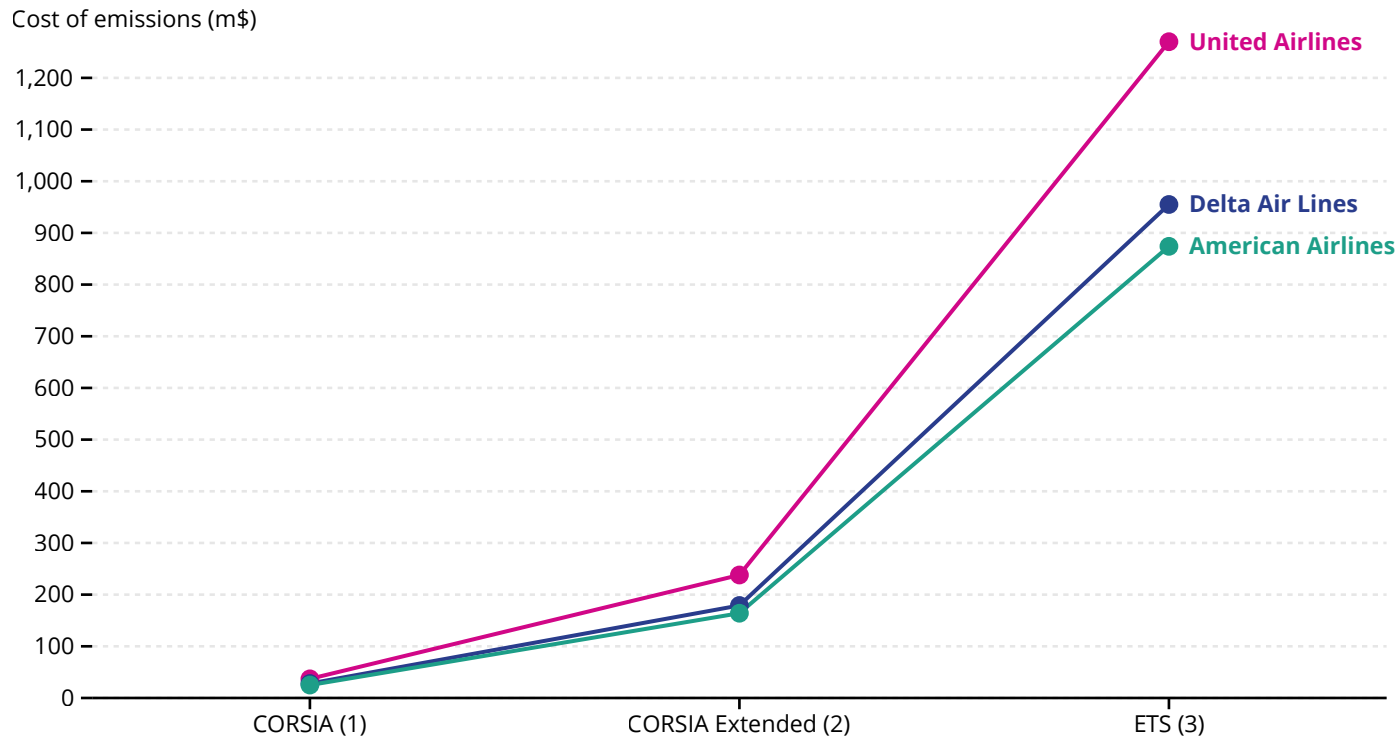
CORSIA would cover just one-fifth of emissions from international flights by 2030, and offset these emissions with cheap and unreliable carbon credits. The 126 member

states that committed to participate in CORSIA from 2024 account for only 66% of aviation's global CO_2 emissions, below the threshold set in EU law. At the latest ICAO General Assembly in September 2025, no measures were adopted to strengthen CORSIA.

On top of this, inaction by major emitters such as the US, China, and India strengthens the case extending the EU ETS to all flights. Under CORSIA, US airlines would owe around $130 million for 2024 emissions (assuming credit price of $15/t$CO_2$), but there is no indication the US will enforce these payments, despite seemingly 'participating' in the scheme. The US ties its continued support on wider participation from other major emitters, such as China and India, neither of which has shown any interest in joining the scheme. Even if fully enforced, CORSIA would still price only a fraction of carbon emissions because of its high baseline and low climate ambition. If all US airlines' 2024 carbon emissions under CORSIA covered flights were priced at a fairer level of \$80/tCO_2, their costs could rise to about $4.4 billion. Around forty times more than current obligations.

Projected 2024 CORSIA costs for the three most polluting US airlines

under three scenarios.



1. Costs under the current CORSIA coverage ($15/t$CO_2$)
2. Costs if all carbon emissions were covered under CORSIA covered flights ($15/t$CO_2$)
3. Costs if all carbon emissions were covered under CORSIA covered flights and were priced at a fairer level ($80/t$CO_2$).

***Note:** US airlines will not face any costs until the US implements penalties for CORSIA non-compliance into national law.*

Source: Carbon Market Watch, 2026.

At COP29, discussions began on setting a "New Collective Quantified Goal," which significantly raises the ambition for climate finance. Countries are now committing to provide at least $300 billion annually, with a broader aim of mobilising $1.3 trillion in international climate finance by 2035. According to the EU, its 27 member states contributed €28.6 billion in 2023. If the bloc were to contribute proportionally to the new $300 billion target - similar to its share of the previous $100 billion goal - it would need to mobilise over €79 billion by 2035.

Beyond the EU's share to the New Collective Quantified Goal, proceeds from the aviation ETS should also be used to support Least Developed Countries (LDCs) and Small Island Developing States (SIDS) to decarbonise their aviation sector. This would also help bolster international support for the EU to expand the ETS scope, as raising revenues could be shared equitably, with a focus on low-income countries.

Beyond the exemption of extra-EEA flights, the approach to private aviation shows another obvious fairness gap of the current set-up. Private jets emit between five and fourteen times more per passenger than commercial flights, most are short-haul and have greener alternatives, and their emissions rose by 46% between 2019 and 2023. In western Europe, a public majority agrees that those who fly in private jets should be charged more per flight. Despite all this, two-thirds of private jet emissions in the EU are not captured by ETS carbon pricing. This is largely because many operators fall below existing thresholds for aircraft weight, annual emissions, or flight frequency.

Private jet users are among the wealthiest travellers, and their choice of flight is typically the least price-sensitive. This makes private jet flights well-suited for targeted carbon pricing that will raise revenue for the fair transition. With ETS2 coming into effect, it highlights the inadequacy of current aviation rules as people using a fossil-fueled car will pay a carbon price, while jetsetting millionaires are largely exempted from ETS1. It is high time the EU ETS makes these limousines of the sky pay a fair share for their pollution. Pricing all private jets flying within and from the EEA with a price multiplier of four (x4) could raise around €800 million annually by 2030 or €1.2 billion if arriving private jet flights are also covered.

At the same time, free allocation for so-called 'sustainable aviation fuels' requires stronger safeguards. In 2024, €100 million worth of EU ETS allowances was granted to 53 airlines to encourage the uptake of bio-kerosene. However, without strict sustainability criteria, bio-kerosene can cause significant environmental harm. Subsidies (including free allocations) should therefore be limited to e-kerosene.

Aviation's non-CO_2 impacts are significant for the climate. Those defined as non-CO_2 effects include condensation trails ('contrails') – the white stripes often left by aeroplanes in the sky. Contrails can have a climate-warming effect up to three times higher than carbon dioxide. The scope of Monitoring, Reporting, and Verification (MRV) for non-CO_2 effects should be automatically extended to cover all departing and arriving flights to make monitoring, and understanding, of aviation's total climate impact more comprehensive.

In 2019, fewer than 5% of flights caused around 80% of European contrail warming. Adjusting flight routes or altitudes to avoid contrail-forming conditions can cut non-CO_2 effects by almost 75%, with only marginal increases in costs (0.08%) and fuel use (0.11%). Contrail avoidance should be supported by using a carefully limited share of free allowances that would otherwise have been gifted to airlines to encourage the uptake of e-kerosene, to prevent over-incentivisation.

8 Cover smaller vessels and all international voyages

Shipping sector should pay more for its pollution

A significant amount of EU shipping emissions have remained outside the scope of the EU ETS so far, and the opportunity must be grasped in this revision to incentivise decarbonisation.

In 2024, the EU ETS generated about €38.8 billion of revenue, of which €2 billion was collected from shipping companies operating routes covered by the scheme. Still, smaller vessels in the 400-5000 gross tonnage range are currently exempt from European carbon pricing, although their unaccounted emissions are significant (17.8 megatonnes of CO_2 per year). These vessels should be brought into the system to bridge the price difference between dirty fuels and clean technologies. The inclusion would support the uptake of scalable solutions, such as battery-electric and hydrogen propulsion, particularly for shorter voyages where smaller vessels dominate.

These smaller vessels also contribute heavily to coastal air pollution, including in urban centres. Their exclusion undermines both the environmental integrity and the credibility of the ETS, leaving a sizable share of maritime emissions unpriced while other sectors, including road transport and buildings under ETS2, are brought into the carbon pricing framework.

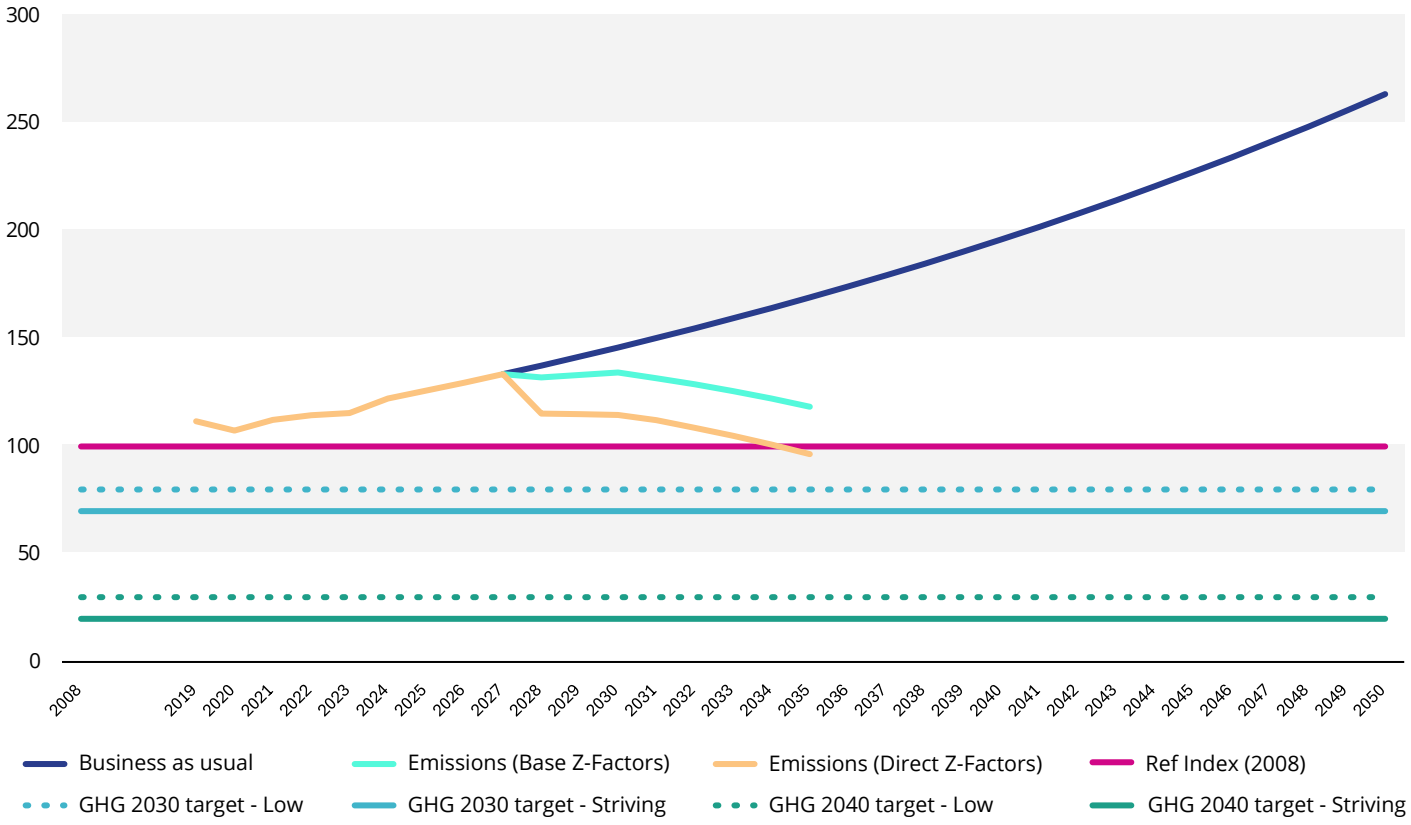
Likewise, only half of the emissions from extra-EEA shipping voyages are covered by the EU ETS. This coverage should be increased to 100%, and the extra revenues should be used to support shipping decarbonisation in the most vulnerable countries, which would help to build trust that the EU is a credible and supportive partner towards a just and equitable transition across the globe.

During the negotiations for a global mechanism, the International Maritime Organisation's (IMO) Net-Zero Framework (NZF), the US and other oil-producing countries framed EU action as neocolonial, turning low-income countries against the NZF. Notably, a clear majority of the countries voting in favour of delaying the NZF were Least Developed Countries (LDCs) and other low-income countries. Using ETS shipping revenues for their decarbonisation efforts would not only be fair, but also help build trust in the EU, and multilateralism in general.

The Commission has been tasked with proposing an extension of ETS to cover more than the current 50% of emissions from international voyages if a Paris-aligned measure is not adopted. The vote on adopting a global mechanism was postponed from last October to the end of 2026. Even if IMO member states adopt the already agreed NZF, the current agreement would reduce shipping emissions by a projected maximum of 10% by 2030 (relative to 2008 levels). This is far short of not only the 45% required by the Paris Agreement, but also the 20-30% required by the IMO's own climate strategy. The NZF is therefore far from Paris-aligned.

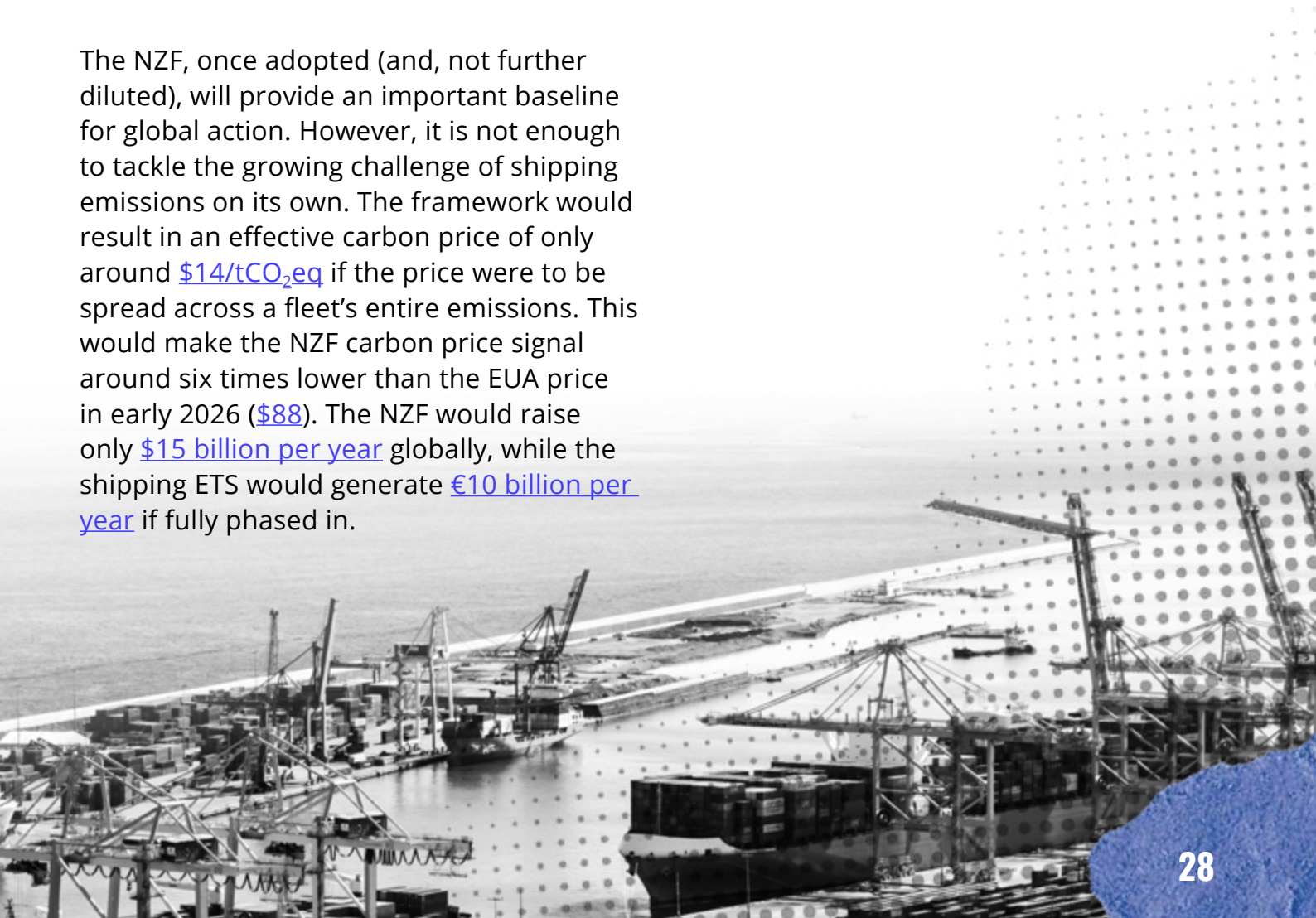
Projected evolution of total greenhouse gas emissions from international shipping

(indexed to 2008 = 100) - assuming 3% annual growth



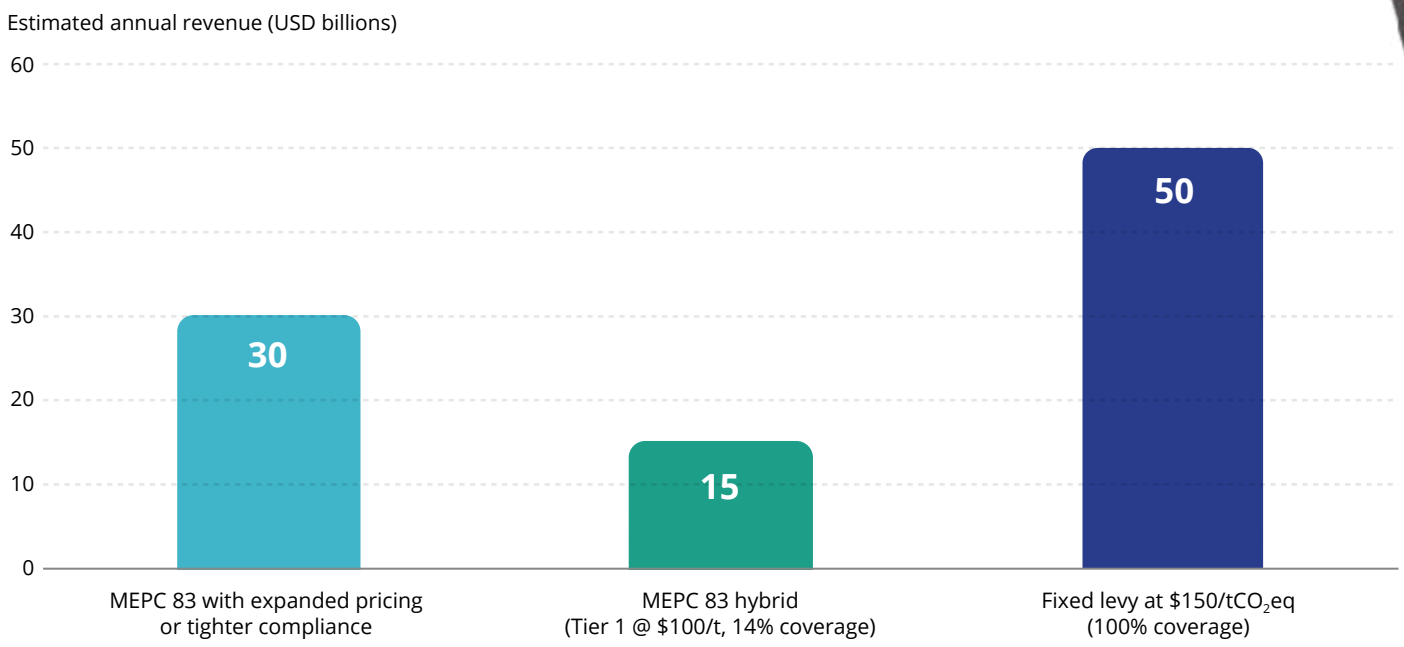
Source: Michele Cincera et al., From Compromise to Consequence: Evaluating the IMO's Net-Zero Framework and its implications for the EU, Carbon Market Watch, 2025.

The NZF, once adopted (and, not further diluted), will provide an important baseline for global action. However, it is not enough to tackle the growing challenge of shipping emissions on its own. The framework would result in an effective carbon price of only around $14/tCO$_2$eq if the price were to be spread across a fleet's entire emissions. This would make the NZF carbon price signal around six times lower than the EUA price in early 2026 ($88). The NZF would raise only $15 billion per year globally, while the shipping ETS would generate €10 billion per year if fully phased in.



Estimated annual revenue (billion $)

under different scenarios.



Source: Michele Cincera et al., From Compromise to Consequence: Evaluating the IMO's Net-Zero Framework and its implications for the EU, Carbon Market Watch, 2025.

As is the case for aviation, free allocation of ETS allowances for biofuels is ineffective and wasteful. Any ETS funding (be it monetary or in the form of free allowances) should only be used to support technologies that can be scaled in the long-term and are truly sustainable, which is not the case with biofuels. If free allocation must be introduced, the allowances should at least be capped annually for each technology.

9 Null and void the zero-rating of biomass

It sounds good on paper, but in the real world it drives deforestation

The burning of biomass in installations covered by the ETS has increased steadily in both absolute and relative terms, and in 2024 it represented more than a fifth of total emissions from ETS1 stationary installations.

However, the Renewable Energy Directive (RED) falsely assumes a "zero-rating" of biomass in the energy sector, so these extra emissions occur in addition to EU ETS emissions but are not priced. The justification for incentivising biomass emissions is the incorrect assumption that emissions from biomass harvested and burned are magically compensated due to the automatic and swift regrowth of the burned biomass. Yet it could take decades to centuries for the replanted trees (and the carbon sequestrating ecosystem they were part of) to mature: the European Academies Science Advisory Council concludes that biomass burning is "not effective [...] and may even increase the risk of dangerous climate change."

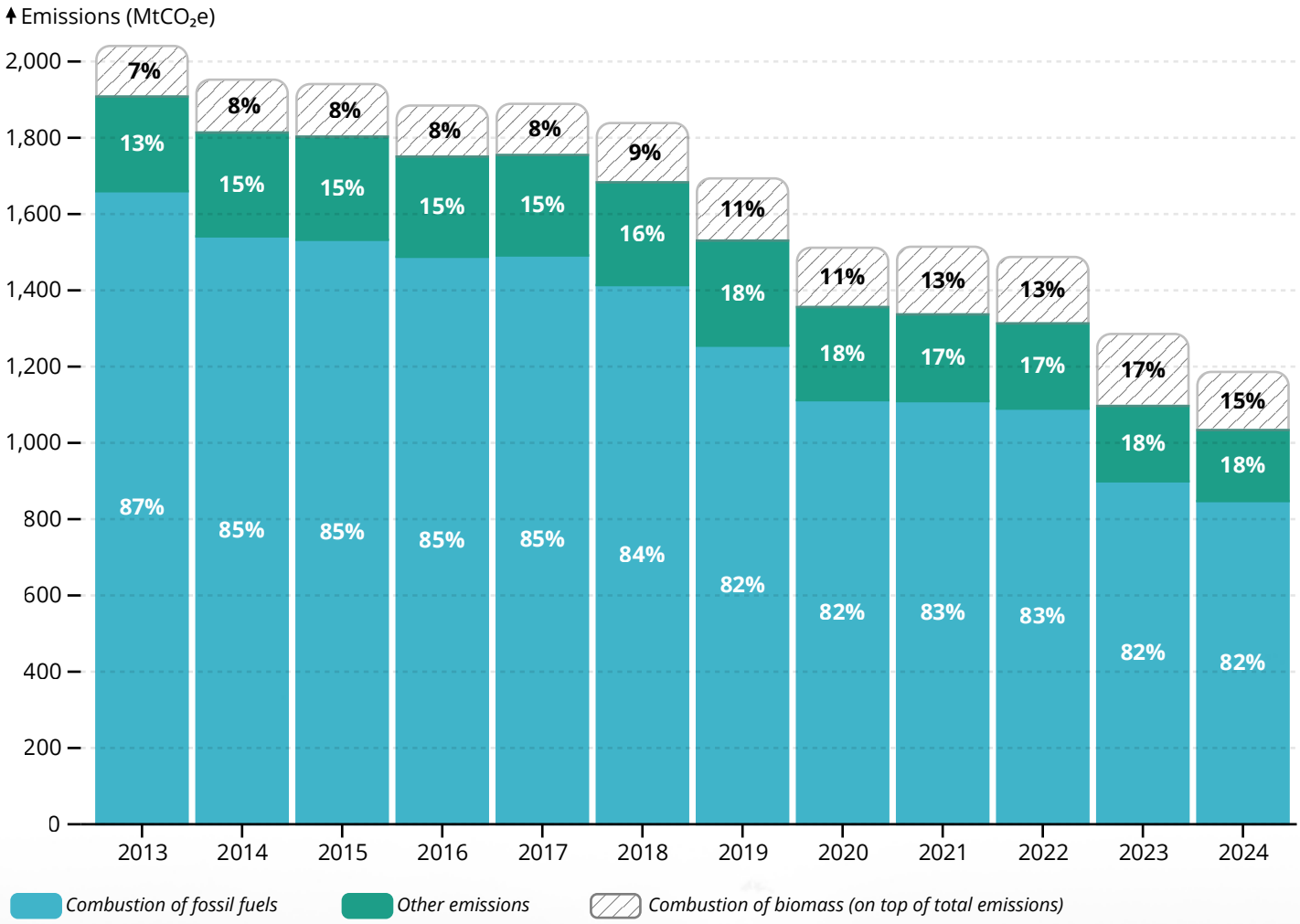
The zero-rating creates a perverse incentive to swap fossil fuels for biomass throughout the EU ETS. Burning woody biomass for power generation actually emits more than coal in the short term, with carbon debts persisting for up to a century if the forest actually regrows (and isn't replaced by a tree plantation, agriculture or urban development – a big if).

Additionally, the RED framework is riddled with loopholes, and the criteria are simply not strong enough to ensure that any burned biomass is 'sustainable'. To make matters worse, the EU land sink is being pushed to its limits and risks crashing. Member states are not on track to reach their LULUCF targets, largely because of increased burning of biomass for energy – half of all harvested woody biomass is being burned in the EU.

Disincentivising the burning of biomass in ETS installations (power and industry, as well as biofuels) must be a priority for this revision. In Paris Agreement-relevant timeframes, the atmospheric impacts of a CO_2 molecule are the same whether originating from a tree or a barrel of oil.

Unaccounted emissions from stationary installations

In 2024, biomass combustion contributed an additional 153MtCO$_2$e beyond the cap, hence they are shown on top of total combustion emissions from installations.



Source: CMW own calculations based on European Commission data.

10 Leave the ETS2 alone – for once

Stop delaying and diluting ETS2, leave it off the chopping block.

The new emissions trading system for road transport and buildings (ETS2) is outside of the scope of this ETS review, and must be kept off the negotiating table. Despite ETS2 not even having started yet, it has already been significantly weakened by policymakers.

The introduction of the scheme was delayed by one year to 2028, leading to around €50 billion in forgone auctioning revenues in 2027 (assuming a carbon price of €60/t CO_2 equivalent to €45 in 2020 values) for climate investments and postponed climate action. On top of this, the suggested Market Stability Reserve (MSR2) reform would significantly disincentivise much-needed climate investments and increase the system's CO_2 emissions by up to 600 million tonnes. Further postponement and revision of key ETS2 elements would substantially weaken the instrument's effectiveness and undermine the regulatory stability that businesses and households rely on to make long-term investment decisions.

Lawmakers have been undermining its predictability and effectiveness seemingly since the day it was agreed upon. Now it's time to leave it alone, let it start, and await the next scheduled revision in 2028 instead of constantly tinkering with it before it has even commenced operation. In the 2028 ETS2 review, the climate and social ambition of the system will need to be defended and reinforced by, for example, uncapping the size and extending the duration of the Social Climate Fund.

Rather than tampering with ETS2, member states should do their homework. More than a third of member states still have to transpose the ETS2 part of the ETS Directive, despite the deadline of 30 June 2024. As of April 2026, only one Social Climate Plan has been approved, and six others have been submitted for assessment. 20 member states are yet to submit their Social Climate Plans outlining how they will support vulnerable households through the energy transition. Member states need to catch up, transpose ETS2, and deliver robust Social Climate Plans with inclusive stakeholder consultation.

On top of these legal obligations, member states must intensify their preparations at home to deliver climate action and ensure that no one is left behind during the energy transition. It isn't an either-or choice; member states must tackle climate change and protect the most vulnerable people in our societies.

Member states should top-up the financing of their Social Climate Plans by going beyond the 25% minimum co-financing rate and making use of additional financing sources such as the newly established frontloading facility, revenues from early ETS2 auctioning and available ETS1 revenues, such as those from the Modernisation Fund. Transparent reporting and accountability from both member states and the Commission is critical to ensure transparent investment of all ETS2 revenues to lower emissions in buildings and road transport, and support people in the transition. Stakeholders must be included in the overall planning of how ETS2 revenues will be managed to ensure effective spending and social buy-in.

Carbon pricing alone cannot deliver the rapid emissions reductions required in the buildings and road transport sectors. Member states need to urgently implement strong complementary climate, social and fiscal policy to drive decarbonisation, facilitate investments and support lower-income groups. Complementary measures are essential to the success of ETS2, both to unlock its full decarbonisation potential, ensure a socially acceptable ETS2 price and deliver a just transition.

CONTACT

Lidia Tamellini

Policy expert on EU industrial decarbonisation

lidia.tamellini@carbonmarketwatch.org

Jenny Helle

Policy expert on aviation and shipping decarbonisation

jenny.helle@carbonmarketwatch.org

Emma Wikström

Expert on EU carbon markets (focus ETS2)

emma.wikstrom@carbonmarketwatch.org

Meili Vanegas Hernandez

Researcher and data analyst

meili.vanegas-hernandez@carbonmarketwatch.org

Wijnand Stoefs

Lead on EU policy

wijnand.stoefs@carbonmarketwatch.org

EDITOR

Gavin Mair

Communications specialist

gavin.mair@carbonmarketwatch.org

GRAPHIC DESIGN

Quentin Geluyckens

Curious Cowboy

CARBON MARKET WATCH