

POLICY PAPER

**Raising the bar: Bellona Europa's
assessment of the Commission's ETS
review proposal**

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INTRODUCTION

On 17 July 2026, the European Commission published its review proposal for its cornerstone climate policy: **the EU Emissions Trading System (ETS)**. In doing so, it fired the starting gun on a key policy file for a lengthy negotiation process which will take months to conclude.

Much is at stake: **the ETS is one of Europe's most effective tools for reducing industrial carbon emissions and building a strong investment case for European businesses to decarbonise their production and operations.** Whether it will achieve these goals depends on how this instrument is modernised to remain fit for purpose in a changing socio-economic, political and climate context.

Many different stakeholders have interests at stake in this review. On the one hand, some business associations and companies advocate for more relaxed timelines and less ambitious climate targets, believing this will safeguard their short-term competitiveness on global markets. Bellona Europa has already explained in a [recent article](#) why this argument is fundamentally flawed: the ETS is not only an effective tool to reduce Europe's dependency on fossil fuels and its exposure to global energy price shocks, but also one of Europe's strongest levers for enhancing the competitiveness of its industrial sector worldwide.

On the other hand, climate NGOs, think tanks, academics and companies that have already begun investing in decarbonising argue that **a more ambitious ETS is the key to unlock investment**

and modern technologies, improving air quality and building long-term economic resilience.

In this policy paper, Bellona Europa assesses the Commission's proposal and presents its recommendations for a stronger ETS. The paper is organised around the key elements of the system that determine its ability to deliver a strong decarbonisation incentive and meet the climate targets, with each element corresponding to a chapter:

- Free allocation and carbon leakage prevention
- Market Stability Reserve
- Linear Reduction Factor
- The use of ETS revenues
- International carbon credits
- Carbon removals

For readers unfamiliar with these concepts, an accessible introduction can be found in Bellona Europa's recent [position paper](#), which explains each element and sets out its critical role in determining the ETS's effectiveness.

Each section of this paper follows the same structure: first, what the Commission proposes to modify; second, what Bellona Europa finds problematic about that modification; and third, what we recommend instead.

1 | FREE ALLOCATION AND CARBON LEAKAGE PREVENTION

1.1 Delay of free allocation phase-out and CBAM phase-in

Commission Proposal

For the sectors covered by the Carbon Border Adjustment Mechanism (CBAM), the proposal amends article 10a to **reintroduce 15% free allocation** of allowances (FA).

The CBAM was designed as the alternative carbon leakage protection measure that would replace free allocation as it is gradually phased out.

By reintroducing 15% free allocation, the proposal delays both the phase-out of free allocation and the full phase-in of the CBAM by four years (2038 instead of 2034). This additional free allocation aims to “mitigate the remaining carbon leakage risk”, namely the risk that EU producers in CBAM sectors facing declining free allocation are placed at a competitive disadvantage in international markets where competitors are not subject to an equivalent carbon price.

Why it is problematic

Regulatory instability: modification of CBAM phase-in timeline creates a climate of general uncertainty with negative impacts on decarbonisation investments both in the EU and abroad. CBAM has [driven](#) stronger nation-wide climate action in third countries, and this risks undermining that progress.

Ineffective for decarbonisation: Free allocation has been [proven](#) ineffective for industrial decarbonisation. The CBAM provides a valid alternative carbon leakage solution to some of the highest emitting sectors.

Weaker carbon price signal: the longer FA are provided in the ETS, the weaker the economic incentive to decarbonise, as companies do not have to pay for their carbon emissions.

Lower ETS revenues: the more allowances are allocated for free, the less ETS revenues are collected by the EU and its member states, with consequent losses for public budgets.

What Bellona Europa recommends

Maintain current timeline for phase-out of FA and CBAM phase-in and provide industries with adequate protection from the risk of carbon leakage for their export-oriented production within the current timeline.

1.2 Free allocation conditionalities

Commission Proposal

According to article 10a (3a), starting 1 January 2031, free allocation will be conditional:

- **80%** of it will be disbursed in annual tranches, **conditional upon the approval of climate neutrality plans** by the boards of ETS-covered entities and their verification by the competent authority. These plans must set out a pathway to achieving climate neutrality by 2050, with progress assessed every five years.
- **20%** is only granted within **2 years after the five-year period upon verification that the investments have led to the expected emission reductions**. Investments will need to amount to 100% of the economic value of the free allocation received.

Exceptions and flexibilities include the possibility to form a “pool” for joint investments if there is uneven access to infrastructures among ETS-covered entities, exemption for the 10% best performing installations and for beneficiaries of Innovation Fund, Industrial Decarbonisation Bank’s (IDB) and Industrial Booster funds and anti-relocation provisions.

Why it is problematic

Allocating most emissions permits (80%) just upon approval of a climate neutrality plan without implementation verification is problematic as **it does not provide any reassurances that the plan will be actually implemented**. In the absence of any penalty mechanism for non-delivery of the plan’s commitments beyond withholding that remaining 20%, these plans risk functioning as an access ticket to the bulk of free allocation rather than a genuine driver of decarbonisation.

Making only 20% of free allocation conditional to actual investment in decarbonisation is **unjustifiably unambitious**. Conditionalities would only start after 2030, hence until then ETS covered installations would have all the time to properly plan and implement long-term decarbonisation investments. Disbursing the remaining 20% emission allowances 2 years after the five-year period might make it challenging for sectors highly exposed to carbon leakage or for CBAM-covered sectors which will see their share of free allocation reduced over time.

What Bellona Europa recommends

While Bellona Europa acknowledges the role of free allocation as a carbon leakage protection measure, conditionalities attached to free allocation should be strengthened. In particular, Bellona Europa proposes that:

- **All free allowances should be made conditional on investments** in industrial decarbonisation, strengthening the link between public support and the transition to climate-neutral production.
- This share should continue to be **distributed annually**, rather than only at the end of the allocation period, subject to **regular verification** that the approved decarbonisation investments are being implemented and progressing as planned, preserving carbon leakage protection and investments confidence.
- Should investments not deliver the expected emissions reductions after the five-years period, **proportionate corrective mechanisms** should apply to ensure that free allocation ultimately rewards effective decarbonisation rather than commitments alone.

1.3 Extending Indirect Cost Compensation

Commission Proposal

On Indirect Cost Compensation (ICC) the proposal in its article 10a (6) includes 2 main changes:

- **Extending ICC beyond 2030**
- Mandates for member states to report ICC spending in the National Energy and Climate Plans (NECPs)¹ as well as how they contributed to decarbonisation.

Why it is problematic

The proposal does not change ICC distribution, which is its most problematic aspect.

ICC is currently distributed in a way that compensates industries for the carbon cost incurred on both the fossil and non-fossil electricity consumed, making it a de facto fossil fuel subsidy.

Requiring more clarity around how ICC is spent is a positive addition as previous reports from Member States [were not](#) as transparent as they were supposed to be. However, the level of required information transparency to be included in the NECPs and the consequences of misreporting remain unclear.

What Bellona Europa recommends

Especially for CBAM-covered sectors:

- Reform **ICC so that it [compensates](#) only for the residual carbon costs embedded in non-emitting electricity consumption**, allowing indirect emissions to be fully included in the CBAM.

For all sectors:

- Require at least 50% of ICC received to be earmarked for climate action and energy efficiency
- Require Member States to report on ICC by clearly and unequivocally stating the amount of aid granted per industrial installation, justification for eligibility and documented use of ICC revenues. Foresee penalties when the information provided is not compliant.

2 | **LINEAR REDUCTION FACTOR (LRF)**

2.1 Changes to Emission Allowance Trajectory

Commission Proposal

The Commission proposes an adjustment with 2 subsequent decreases in the annual rate at which the total emissions cap shrinks. **This extends the issuance of new emissions allowances for ETS-covered sectors beyond 2040.**

Article 6a (12 (b)), proposes:

- LRF = 3.7% during 2031-2035.
- LRF = 1.7% from 2036 onward (**or 2.7% fallback if credits are unavailable**).

Obs: Preliminary calculations indicate that a 1% change in the LRF between 2035–2040 cumulatively equates to roughly 260 million allowances—though this requires confirmation when Union-wide quantity of allowances values are published in September 2028.

Why it is problematic

The proposed trajectory significantly increases the risk of **failing to deliver the 85–87% emissions reductions needed in ETS-covered sectors**. Independent assessments from [Climact](#) and [Sandbag](#) estimate reductions could fall below 80%.

The combined effect of the lower LRF, the weaker Market Stability Reserve, and additional allowances for removals could **create a systematic oversupply** that exceeds actual forecasted demand ([Öko-Institut](#)).

This would weaken the carbon price signal and derail critical investments.

What Bellona Europa recommends

Maintain a tighter trajectory before 2035—stick to 4.4% or even increase it—and only revert to a softer trajectory if high-integrity international credits are genuinely needed and can add value to the EU's climate action.

The EU must maintain a stable and credible carbon price signal to reward frontrunners and incentivise green investments. Persistent signs of oversupply will undermine the mechanism's ability to generate the revenues needed for industrial transformation and real climate impact. A stricter cap also prevents locking in higher cumulative emissions.

3 | **MARKET STABILITY RESERVE (MSR)**

3.1 Ending Excess Allowance Invalidation

Commission Proposal

In a separate file, the Commission is proposing to immediately **cease the permanent invalidation of excess allowances** in the Market Stability Reserve (MSR).

([COM/2026/153 final](#))

Why it is problematic

Ceasing invalidation of allowances removes a key mechanism for permanently reducing surplus. Combined with the lower intake rate, this **creates an excess reserve pool of allowances** that outpaces projected demand, derails investments, and **weakens the carbon price**.

What Bellona Europa recommends

Maintain the MSR as a credible and effective tool to manage emission allowance surplus by reinstating permanent invalidation to ensure surplus allowances are permanently removed from the market, not just temporarily parked in the reserve.

3.2 Reserve Intake Capacity

Commission Proposal

The MSR's market **absorption of allowances is reduced** from 24% to 12% as of 2028 when above the upper threshold. The limit was also reduced from 1,096 million to 947 million (Article 2 (2)).

Why it is problematic

This **weakens the MSR's ability to absorb surplus** and tighten the market. In other words, the MSR's ability to maintain a strong incentive for decarbonisation.

What Bellona Europa recommends

Amending the proposal to prevent premature release of allowances back into the market while the supply of emission allowances is higher than the actual demand.

Maintain a more robust intake rate of 24% to **ensure surplus is effectively absorbed** and the carbon price signal remains strong.

3.3 Threshold Adjustments

Commission Proposal

Introduces a more gradual release of allowances stored in the MSR when the surplus of circulating allowances in the market (TNAC) is still relatively low (between 300 and 400 million allowances). Thus, the **amount released would be tailored to the size of the surplus** (Recital 87 + Article 2 (3)).

The MSR thresholds and release quantities would be updated to reflect a steadily shrinking amount of allowances. Indeed, from 2029 onwards, the thresholds would decrease by 4% every year, helping the MSR remain responsive as the overall number of allowances in circulation declines (Recital 88+ Article 2 (3)).

Changes to the way the TNAC is calculated by excluding historical aviation emissions (173 million allowances) (Article 2 (1)).

Why it is problematic

The first two modifications are positive and help ensure the MSR remains effective as the ETS cap becomes smaller over time.

However, excluding historical aviation emissions from the TNAC calculation makes the **market surplus appear smaller than it actually is**.

As a result, the threshold for the MSR to start removing allowances from the market becomes harder to reach. In practice, the effective upper threshold increases from 947 million allowances to around 1.12 billion allowances (947 + 173 million).

This could allow a larger allowance surplus to remain in circulation for longer, increasing the risk of oversupply and weakening the carbon price signal needed to drive decarbonisation investments.

What Bellona Europa recommends

Retain the proposed reforms that make the MSR better adapted to a shrinking ETS market, including the declining thresholds and more flexible release mechanism.

With the aviation adjustment, the MSR may absorb fewer allowances despite continued oversupply risks. **A recalibration of threshold values is needed to preserve the MSR's effectiveness.**

This would ensure that allowances can still be removed from the market during the 2030-2040 period, reducing the risk of oversupply and preserving a strong carbon price signal.

4 | **ETS REVENUES**

4.1 Loosened climate spending requirement

Commission Proposal

Revenue use by Member States (MS) (Chapter III, Article 10(3)):

- A new requirement for MS to spend at least 50 % of their revenues (share of total without spending for Indirect Cost Compensation) for decarbonising ETS sectors is introduced.
- The other 50 % **may** be spent on climate related activities and residual carbon leakage protection; in the current version of the Directive the 100 % of revenues **shall** be spent on climate related activities and residual carbon leakage protection.
- New overarching rules:
 - **Funding should not prolong usage of fossil fuels** for power generation and it must be consistent with transition towards low-carbon economy.

Disbursement deadline: MSs shall disburse their revenues no later than the end of the third calendar year following the year in which the revenues were generated.

Why it is problematic

Albeit increased stringency and focus of revenue use for 50%, on ETS 1 sectors, the climate related **spending obligation for the other 50% is loosened** (change from shall to may), allowing MSs to use money for non-climate related purposes.

What Bellona Europa recommends

- **100 % of ETS 1 revenues must be spent on climate-related activities.**
- Specifics on how investments in industrial decarbonisation can be considered consistent with climate targets are needed (a simple and effective example can be found in the [Bellona Criteria](#)).
- Penalties should be foreseen if the information is not accurate.

4.2 Flawed financial support allocation criteria in the Investment Booster

Commission Proposal

Industrial Decarbonisation Bank (IDB) and Investment Booster:

- IDB as decarbonisation investment support vehicle is introduced with two phases each fuelled by 400 million allowances (not additional) (Chapter III, Article 10cc).
- The first phase of the IDB is called **Investment Booster** (2028-2030), which will allocate funding on first-come-first-served basis. The distribution should happen through fixed carbon premia, i.e. a fixed subsidy per tonne of product (Chapter III, Article 10cd). The second IDB phase (2031-2040) should use competitive auctioning for allocation and has an emphasis on Carbon Contracts for Difference² (CCfD) as payout mechanism (others are possible) (Chapter III, Article 10ce).

Why it is problematic

First-come-first-served allocation and a fixed payment per tonne are simple to administer and shift some risk away from companies, but they also mean the EU gets less emissions reduction for each euro spent and so less overall progress on decarbonising industry in comparison to more competitive and targeted approaches. The **First-come-first-served principle in itself does not incentivise cost-efficient selection of decarbonisation options**. Therefore, it must be complemented by complex terms and conditions to ensure this.

A fixed carbon premium is not precise in addressing decarbonisation barriers, such as, for example, the uncertainty surrounding the CO₂ price or input costs, this means either that investment risks are not sufficiently addressed and investments do not happen or the IDB must increase its spending per project, and therefore risk-share, reducing the funds available for other projects.

What Bellona Europa recommends

More competitive allocation schemes and CCfDs should be introduced already in the first phase of the IDB.

The necessary follow-up terms and conditions must entail climate effectiveness, systemic efficiency, scalability, and prevent harm to other environmental and social objectives.

5 | **INTERNATIONAL CARBON CREDITS**

5.1 The purchase and indirect use of international credits

Commission Proposal

Up to 260 million allowances from the ETS cap will be reserved between 2036 and 2040 to enable a dedicated EU facility to purchase up to **260 million tonnes of high-quality international credits**. This represents around 2 fifths of the up to 5% of international credits that the EU can use to meet its 2040 climate target.³

Why it is problematic

- The proposal effectively turns the European Climate Law's provision allowing "up to 5%" **international credits from an optional flexibility into a built-in part of the architecture**, and a possible target in itself.
- A less ambitious ETS means **fewer emission reductions from industrial emitters** covered by the market. This shifts more of the effort onto other sectors of the economy (e.g., agriculture, road transport, land sinks...), while increasing reliance on a limited supply of international credits.
- ETS revenues spent on international credits are revenues not invested in decarbonising European industry. This is a missed opportunity to strengthen EU competitiveness.

What Bellona Europa recommends

Set an ambitious LRF as the baseline. **Only if high-quality credits are available and their use is needed, the LRF should be revised**, in proportion to the volume of credits actually used.

Maintain the indirect approach, with a facility purchasing international credits.

5.2 Availability and quality of international credits

Commission Proposal

Whether these credits can be ultimately used will depend on a 2033 assessment which will evaluate whether sufficient high-quality credits are available.⁴

Why it is problematic

International credits **should not be considered equivalent to domestic emission reductions**. Whether they deliver the same climate outcome (one tonne of CO₂ reduced or permanently removed), depends on the type of project, its environmental integrity, and strong accounting, monitoring and verification.

What Bellona Europa recommends

Ensure international credits deliver **climate outcomes equivalent to domestic emission reductions**. They should meet the same high standards applied within the EU, including permanence, and robust accounting and verification.

5.3 The review clause of international credits

Commission Proposal

If the assessment concludes that such credits are not available, **the linear reduction factor will increase from 1.7% to 2.7%**.⁵

Why it is problematic

The inclusion of a review clause in 2033 is welcome. However, the sequencing is backwards. **The ETS ambition is reduced upfront.**

What Bellona Europa recommends

The opposite approach would be more appropriate: First, establish whether these credits are available and whether their use is needed; second, once their availability is confirmed, discuss whether they should play any role.

6 | THE INDIRECT INTEGRATION OF PERMANENT CARBON REMOVALS

6.1 Use of ETS allowances to purchase permanent removals

Commission Proposal

From 2031 to 2040, up to **250 million additional EU allowances will be auctioned** to enable the European Commission to finance an equivalent volume of **permanent removals (DACCS and BioCCS)** certified by the CRCF.⁶

ETS operators can compensate their own emissions with CDR units from the storage of biogenic CO₂. **A corresponding amount has to be cancelled** from the 250 million EUAs.⁷

An additional 10 million allowances from within the cap may be used if the 250 million allowances added to purchase allowances are not sufficient to finance the purchase of CDR.

Why it is problematic

A significant concern is that additional allowances will **enter the ETS before the corresponding removals have been delivered**. This creates a risk that the ETS cap is increased based on expected future removals rather than actual climate outcomes.

2031 is not yet the residual emissions phase. The priority over the next decade should remain cutting emissions as much as possible, while building domestic CDR capacity in parallel.

There is uncertainty about whether the volume of removals which is planned to be purchased would qualify as a **“realistic contribution”, as outlined in the European Climate Law**. While the demand signal for the CDR sector is welcome, the scale proposed is ambitious compared with the current availability and near-term deployment of removals, creating a risk that the ETS relies on removals that may not be delivered as expected.

EUAs revenues alone are very unlikely to be enough to fill in the carbon removals technologies funding gap.

What Bellona Europa recommends

The indirect interaction between permanent CDR and the ETS, managed by the Commission, is the right approach as it offers greater scope for stronger safeguards than direct market integration. This approach should be maintained.

However, **either ensure that removals only influence the ETS once they have been physically delivered**, or establish a mechanism to cancel allowances if the expected removals do not materialise.

Clarify the expected volume of removals to be purchased, including a cap for BioCCS including when generated by operators directly, and how any funding gap will be addressed.

6.2 Management of unused allowances

Commission Proposal

If the allowances reserved for removals are not used for this purpose before 2041, they will be returned to the overall ETS allowances quantity. This means that unused allowances will become available in the ETS.

Why it is problematic

If unused allowances aimed for removals purchase should end up being incorporated in the broader ETS's pool of allowances after 2041, the result would be that **additional emissions space would be created without a corresponding climate benefit.**

What Bellona Europa recommends

Ensure that any **unused allowances** from the 250 million allocation are cancelled rather than entered in the ETS.

6.3 Review of the scope of removals

Commission Proposal

A review by 2034 will assess 1) whether temporary or nature-based removals could be integrated to the system, and 2) whether ETS operators should be allowed to purchase removals directly.⁸

Why it is problematic

Temporary or nature-based removals do not provide the same level of permanence as emission reductions and permanent carbon removals.

What Bellona Europa recommends

Maintain a clear scope limited to only permanent CDR (currently CCS-based removals). **Temporary and/or nature-based** removals should be supported through dedicated, separate policies but **should not interact with the ETS.**

6.4 Sustainability safeguards for removals

Commission Proposal

The impact assessment argues that biomass-related risks should be managed through strict sustainability criteria and existing regulatory frameworks, rather than addressing them through the ETS. It also notes that the broader incentive structure for biomass should be reviewed.⁹

Why it is problematic

Additional sustainability criteria to make sure CDR deployment is within planetary boundaries (biomass, water consumption, soils etc) were **not considered**. However, the impact assessment rightly acknowledges that the incentive structure for biomass should be reviewed.

What Bellona Europa recommends

Complement the ETS review by

- 1) establishing a **dedicated target** for permanent CDR,
- 2) **revisiting the zero-rating of biomass** to ensure that emissions from biological sources are properly accounted for and that only genuine removals are incentivised,
- 3) **ensuring a strong framework for EU land sinks (LULUCF)**, and
- 4) creating a strategy to define, identify, reduce and counterbalance residual emissions.

REFERENCES

1 [NECPs](#) are national plans which should “outline precise actions and policies to achieve the 2030 climate and energy targets and fulfil the broader objectives of the Energy Union”.

2 CCfDs cover the abatement costs of low carbon production that are not covered by the ETS price, therefore hedging against carbon price uncertainty and allows investment even if carbon prices are low. The base mechanism can be complemented by hedging mechanisms against energy carrier price uncertainties.

3 Article 9b, paragraph 1

4 Article 9b, paragraph 3

5 Article 9b, paragraph 4

6 Article 9c, paragraph 1

7 Article 9c, paragraph 5

8 Article 9c, paragraph 8

9 Impact assessment, Annex 8, Part II



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Bellona Europa is an independent, non-profit organisation that meets environmental and climate challenges head-on. We are result-oriented and have a comprehensive and cross-sectoral approach to assess the economics, climate impacts and technical feasibility of necessary climate solutions. To do this, we work with civil society, academia, governments and polluting industries.