

Position Paper

Making Free Allocation work for Industrial Decarbonisation

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Why conditionality matters

Under the EU Emissions Trading System (EU ETS), industrial installations must surrender one allowance for every tonne of CO_2 they emit. If they have to purchase all allowances at auction, **European producers face carbon costs that foreign competitors may not face,** potentially encouraging production to relocate abroad. This is known as carbon leakage.

Free allocation addresses this risk by providing some allowances at no cost, **reducing the direct financial burden on installations exposed to international competition**. In principle, free allocation does not eliminate the incentive to decarbonise: installations still face the opportunity cost of using allowances, as emissions reductions allow them to sell surplus allowances and generate revenue.

Free allocation is a temporary carbon leakage protection measure, for some sectors, it is intended to be replaced as the CBAM is phased in. While free allocation reduces the carbon cost burden on domestic producers, CBAM addresses carbon leakage at its source by applying an equivalent carbon price to imports, ensuring foreign competitors face comparable carbon costs rather than shielding European industry from them.

Drawbacks of free allocation for decarbonisation

As free allocation to ETS-covered industrial installations is conditional on their production decisions, it can distort those regarding production quantity, variety and investment decisions. For example:

1 **Distortion of production and investment decisions**

As allocation is linked to industrial production decisions, it can distort decisions on production quantity, product variety and investment. For example, allocation based on historical activity can act as a production subsidy for emissions-intensive goods (Monjon and Quirion 2011). Free allocation can be understood as a transfer that lowers firms' fixed costs, keeping less productive and more emissions-intensive product lines profitable when they might otherwise exit (Alder et al. 2025).

2 **Over-allocation and windfall profits**

Excessive allocation to certain installations can allow them to pass material carbon costs on to customers while retaining free allowances, generating windfall profits (European Court of Auditors 2020).

3 **Lost public revenues**

Allowances distributed for free represent foregone revenues for the EU and Member States, which could otherwise be used to de-risk decarbonisation investments or provide direct financial support.

Taken together, these drawbacks can make the current distribution of free allowances counterproductive to the EU ETS objective of reducing emissions cost-effectively.

To overcome this, the solution under discussion is to make **free allowances conditional on companies implementing decarbonisation plans at installation level**. This would help reconcile carbon leakage protection with industrial decarbonisation by linking continued protection, where alternatives such as carbon border adjustments are not available, to credible progress towards cleaner production.

The advantages of conditionalities for industrial decarbonisation

Conditionality can also help overcome coordination problems that even a high carbon price cannot fully resolve:

1 **Carbon pricing provides an investment incentive, but not necessarily the conditions for investment**

Many decarbonisation investments depend on complementary investments by other actors.

2 **Mutual dependency can delay investment**

For example, a cement producer cannot electrify its kilns without reliable, industrial-scale low-carbon electricity, while a grid operator may be reluctant to expand capacity without committed industrial customers.

3 **Decarbonisation plans can help break this deadlock**

Requiring companies to submit credible plans as a condition for receiving free allowances makes their commitments visible and concrete, giving other actors across the supply chain greater confidence to invest alongside them (Neuhoff et al. 2021).

The Commission proposal: a short step forward

The European Commission's proposal[1] to make free allowances conditional, is a positive step forward. Under the proposed model, from 2031, **80% of free allowances to obliged ETS installations would be distributed in annual tranches** following approval of an Invest in EU decarbonisation plan for these installations, **while the remaining 20% would be withheld** until verification of the required investments and expected emissions eductions after the five-year allocation period. The proposal also requires investments in EU decarbonisation amounting to 100% of the economic value of the free allowances received ("use-for-value").

However, the proposed approach presents several challenges:

- **Limited accountability for implementation:** approval of a decarbonisation plan is not sufficient to ensure that it is implemented. With no equivalent annual link between progress and free allocation, most allowances could be distributed without demonstrating progress against the plan.
- **Delayed conditionality:** withholding 20% of allowances until the end of the five-year period risks making it more attractive for companies to forgo that share rather than deliver the required decarbonisation. It also creates uncertainty around the timing of free allocation, particularly for CBAM-covered sectors, where the interaction between deferred allowances and CBAM adjustments needs to remain clear and consistent.

1 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC and Decision (EU) 2015/1814 as regards driving competitiveness and cost-effective decarbonisation

- **Insufficient flexibility in investment planning:** tying compliance to a fixed investment-value requirement risks placing too much emphasis on the amount spent, rather than on wheter the investments fit the installation's decarbonisation pathway and intended emissions reductions.
- **Limited recognition of different circumstances:** installations differ in their technological readiness and access to enabling conditions, such as clean energy and CO_2 transport and storage infrastructure. A one-size-fits-all approach risks failing to account for these differences.

Bellona Europa's proposal: 100% conditional free allocation, distributed annually



Bellona Europa proposes making 100% of free allocation conditional on progress against an approved decarbonisation plan, with allowances distributed annually. This would strengthen accountability while preserving the role of free allowances allocation in mitigating carbon-leakage risks.

Step 1: Approve credible decarbonisation plans

Each installation receiving free allocation should have an approved Invest in EU decarbonisation plan setting out a credible pathway towards climate-neutral production by 2050, in line with the EU climate targets. Plans should include clear interim milestones that drive meaningful progress during the 2030s and avoid postponing essential decarbonisation efforts to the final decade before 2050. In this context, the lead times for large-scale investments must be considered, as well as internal corporate investment cycles, so that no CO2-intensive power plant will be operating beyond 2050.

Installations should have flexibility to determine their own milestones and the sequencing of their decarbonisation actions and investments, reflecting their specific circumstances. However, milestones must be material, time-bound, verifiable and linked to the installation's decarbonisation pathway. Plans should be assessed to ensure that they are credible and sufficiently ambitious, with appropriate progress verification. Since decarbonisation often relies on processes that have not yet been tested on a large scale, it is possible to make well-funded adjustments to the plans, which nevertheless must be in line with the EU-climate targets.

Attachment points for this proposal are the already implemented Climate Neutrality Plans. These are required among others for installations whose greenhouse gas emissions exceed the 80th percentile of emission levels for their relevant product benchmarks. Other attachment points could be the already existing reporting frameworks like Task Force on Climate-related Financial Disclosures (TCFD) standards or the Corporate Sustainability Reporting Directive (CSRD).

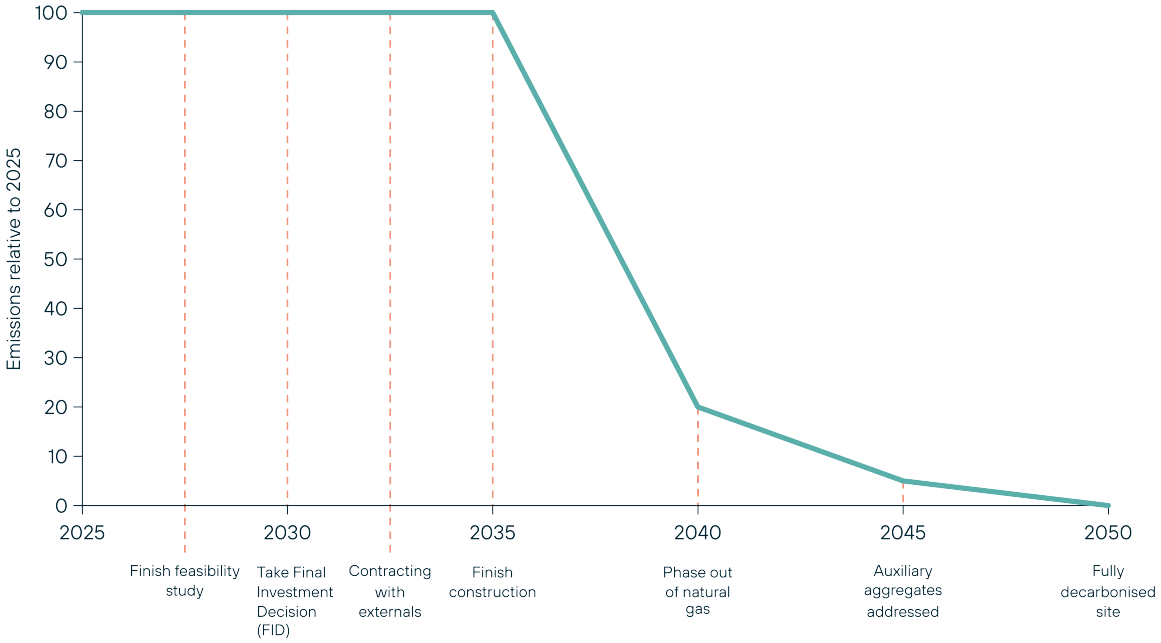


Figure 1: Illustrative decarbonisation plan milestones over time and emission reduction pathway

Step 2: Link annual free allocation to progress

Each year, the release of free allowances should depend on whether the installation has met the milestones set out in its approved plan. Where milestones are not achieved, the reasons should be assessed and appropriate corrective measures applied. Genuine delays caused by factors beyond the installation's control should be distinguished from failures to act, while repeated or unjustified underperformance should have consequences for allocation. This creates the necessary pressure for companies to develop realistic and credible plans as well as the necessary incentives to increase the decarbonisation efforts if plans are overrun. This is important as climate change mitigation and therefore the EU climate targets require timely action.

This approach would ensure that conditionality applies to the full allocation, rather than only to a share withheld until the end of a five-year period. It would also provide greater predictability for industry and avoid the additional timing complications that a deferred allocation could create for CBAM-covered sectors, without guaranteeing full allocation irrespective of performance. In contrast to the Commission proposal, this approach does not demand a "use-for-value" criterion.

Therefore, the financial costs of reaching the milestones can be smaller than the value of the

free allowances. This prevents the creation of perverse incentives that lead to untargeted and inefficient investments, which ultimately do not result in deep decarbonisation, or to the pursuit of inefficient technology pathways, or to investments that will only pay off later due to expectations regarding the CO2 price as well as the availability of inputs and infrastructure.

Flexibility to reflect real-world constraints

Decarbonisation pathways will differ across installations. Where technologies are not yet sufficiently mature or available, plans should require operators to take feasible preparatory steps towards their deployment. Where viable technologies exist but deployment depends on enabling conditions, such as infrastructure or clean energy availability, the framework should recognise these constraints and allow appropriate flexibility. Companies should clearly indicate the requirements for moving forward with their transformation, this would also serve as signal to other market participants and the government. Member States, on the other hand, should establish credible roadmaps for infrastructure availability. This should not remove the responsibility of operators to pursue viable decarbonisation options, nor imply that all existing production routes can or should remain unchanged.

Why this approach?

The proposed approach would:

- **Maintain carbon-leakage protection** while tying the full free allowances allocation to credible decarbonisation progress.
- **Strengthen accountability** by moving beyond plan approval to annual assessment of implementation.
- **Preserve flexibility for industry** to determine the most appropriate investment pathway, without reducing conditionality to a fixed expenditure requirement.
- **Recognise different technological and enabling conditions** while maintaining the expectation that installations take meaningful steps towards decarbonisation.

Free allocation should not simply shield industrial production from carbon costs. Its distribution should also help ensure that European industry is equipped to compete in a decarbonising global economy.

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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.