Rexecode

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Carbon market: the reform misses its own objective

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The revision of the European carbon market proposed on 17 July 2026 aims to strengthen the competitiveness of industry, make its investments more predictable and protect it against carbon leakage; the Commission presents it as relief for industry. Several of its provisions run counter to these objectives.

Compared with current rules extended, Member States would receive through their auctions 55% of the allowances the reform adds to the current cap, free allocation only 23%. The share of the cap allocated free of charge to industry would fall to 32% in 2040, against 41% under current rules extended.

The "correction factor", which reduces industry's free allowances to fit within the cap, would fall to 0.40 in 2040 (0.19 if international credits were unavailable and industry grew as the Commission seeks). It would remove 542 million free allowances from the sectors outside the carbon border adjustment mechanism, over a third of the allowances the benchmarks recognise, and industrial growth would deepen this cut.

The proposed conditionality is unnecessary, the current system being conditional by nature. It would delay part of the allocation and make it uncertain, without strengthening the incentive the carbon price already provides.

The reform adds uncertainty where it promises predictability. The cap after 2036 will depend on a 2033 report on international credits, part of the allocation on criteria yet to be set. The shortfall outside the carbon market also exposes the sectors meeting their target to the risk of being asked for additional effort to make up for it.

Other ways of sharing the same cap could protect industry better, with the ambition unchanged.

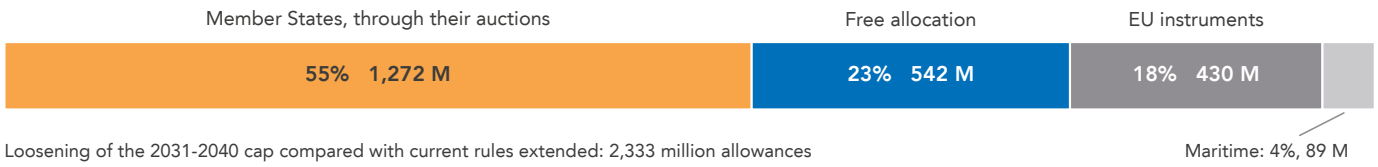
Raphaël Trotignon

A sound instrument, to be adjusted for an increasingly exposed industry

The EU emissions trading system is the most effective and most harmonised tool Europe has to decarbonise its energy production and its emission-intensive industries. On a constant scope, emissions from the stationary installations it covers fell by 48% between 2008 and 2024. It should neither disappear nor lose its long-term ambition. By industry we mean manufacturing, refining, coking and hydrocarbon extraction, together with the installations producing their energy, excluding centralised power and heat generation. The industry covered by the emissions trading system is changing: from 2013 to 2024, its emissions fell by 19% while its output declined by 5%, and its free allocation by 31%. At the same time, it faces increasingly intense competition, from China in particular. The revision raises precisely the question of how to treat industry facing competitors that pay little or nothing for carbon: in 2025, the European allowance was worth 8.5 times the Chinese allowance on average.

Under current rules, free allocation answers this question without weakening the incentive to cut emissions. Each year, an installation surrenders one allowance per tonne emitted. If it does not reduce its emissions, it gains nothing: it surrenders the allowances received and buys those it lacks. Each tonne it avoids earns it the market price, as an allowance sold or a purchase avoided. Free allocation thus offsets part of the compliance cost, but does not discourage emission reductions. The cap always sets the environmental outcome of the covered scope, and trading the CO_2 price, however allowances are brought to market. This is a deliberate choice by the European legislator, based on the risk of carbon leakage, with the aim of reducing the carbon intensity of industrial production, not of eliminating emissions by letting industry decline. The stakes are high: the sectors deemed exposed to the risk of carbon leakage account for around 94% of the system's

Chart 1. Member States receive 55% of the loosening of the cap



Recipients of the allowances the proposal adds to the 2031-2040 cap compared with current rules extended, in millions. Sources: proposal COM(2026) 616, EU Registry, Rexecode calculations.

industrial emissions. Free allocation already covers only 87% of industry's emissions, the rest being bought at the market price.

The promised loosening goes first to the Member States

The Commission presents its reform as relief for industry, through a more gradual trajectory of the cap on authorised emissions. Our calculations, carried out installation by installation on the EU Registry, show that industry would not be the main beneficiary of this "loosening". The 2031-2040 cap would total 5,733 million allowances, against 3,400 under current rules extended. Of this loosening of 2,333 million allowances, Member States would receive 55% through their auctions, free allocation 23% (of which 95% for industry), instruments managed by the EU 18% and maritime transport 4% (chart 1). Member States' auctions would thus rise from 1,938 to 3,210 million allowances over the decade, an increase of 66%, or 191 billion euros of additional revenue at the price of 150 euros per allowance assumed in the impact assessment, 30% of which would go to the EU budget if the own resource proposed for the 2028-2034 EU budget were adopted. Industry would indeed receive 428 million more allowances than under the extended rules; it is the sharing of the loosening that falls short of the stated ambition.

Two provisions produce this outcome. The proposal keeps the key that directs 57% of the available quantity to auctions and 43% to free allocation, but applies these percentages after deducting from the cap fixed volumes for new uses: the Industrial Decarbonisation Bank, purchases of removals and of international credits, maritime transport. These reserves take a tenth of the cap in 2031 and a third in 2040, and each allowance so reserved in practice removes 0.43 allowances from free allocation. The allowances that the carbon border adjustment mechanism removes from free allocation, which currently go to the Innovation Fund, would mostly go to Member States' auctions: 750 of the 1,000 million allowances so removed over 2031-2040. The share of the cap allocated free of charge to industry would thus fall to 32% in 2040, against 41% under the extended rules, before any effect of the border adjustment.

Although the proposal requires Member States to devote at least half of their revenues to decarbonising the covered sectors, no part of this 50% is explicitly reserved for exposed industry: a Member State could meet the obligation through clean energy alone, for example. The European Parliament's rapporteur proposes raising this share to 75% and earmarking for industry, within it, the equivalent of the allowances it buys. These obligations would moreover apply only to the revenues left to Member States: the proposed own resource would reduce the minimum to be devoted to the covered sectors by around 70 billion euros over the decade, and the share paid into the EU budget would not be earmarked for any particular use.

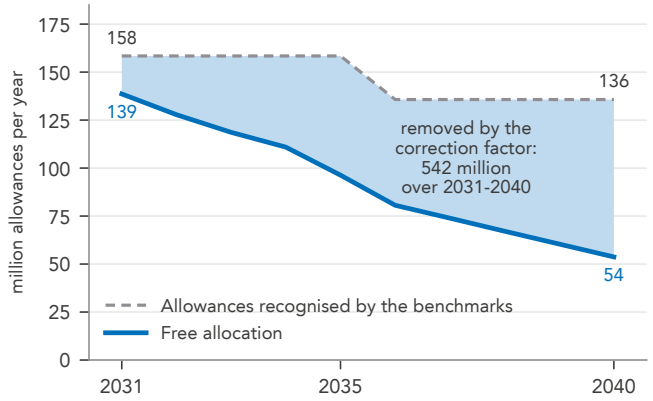
A cut for the sectors without protection

When the allocations calculated on the benchmarks (which better compensate the industries with the lowest carbon intensity of production in their sectors) exceed the envelope the cap reserves for free allocation, a correction factor reduces them all in the same proportion, except precisely for the best-performing installations in each sector. At constant activity at 2023 levels, the Commission's assumption, this cutting factor would be 0.88 in 2031, 0.61 in 2035 and 0.40 in 2040 (and even 0.35 with the cap trajectory proposed by the European Parliament's rapporteur).

This mechanism of reduction contradicts the logic of free allocation. The benchmark states how many allowances an exposed installation needs to be protected from the risk of carbon leakage, provided it is already among the most efficient in its sector. The border adjustment mechanism is meant to replace this protection for five sectors: cement, steel, aluminium, fertilisers and hydrogen. In our Repères No. 6 of June 2023, we already pointed to the risks of this change of regime. For the other sectors, refining, chemicals, glass, ceramics, paper or lime, which the Commission includes in its list of sectors exposed to a risk of carbon leakage, free allocation remains the only protection. Over 2031-2040, their benchmarks lead to an allocation of 1,470 million free allowances; the correction factor would remove 542 million of them, more than a third, and 60% in 2040 alone (chart 2). Yet the European Climate Law asks the Com-

mission to reduce the risk of carbon leakage for the industrial sectors most exposed to it, "including in relation to exports". That would clearly not be the case here.

Chart 2. For sectors outside the border adjustment, the correction factor removes more than a third of the allowances recognised by the benchmarks



Refining, chemicals excluding fertilisers and hydrogen, glass, ceramics, paper, lime and others; constant activity at 2023 levels. Sources: COM(2026) 616, EU Registry, Rexecode calculations.

The more industry grows, the more it pays

The cap limits emissions, which is its purpose; the free allocation envelope follows from it, whatever the level of activity. When output rises, the allowances recognised by the benchmarks rise, but the overall envelope does not move, so the correction factor falls accordingly: each point of annual activity growth lowers it by about 0.05 in 2040. Yet the Commission is aiming for exactly this growth, by proposing to raise manufacturing to 20% of EU gross domestic product in 2035, against 14.3% in 2024 (proposed Industrial Accelerator Act, COM(2026) 100, Article 2). Under this objective, the allowances industry would have to buy in 2040 on top of its free allocation would rise from 282 million to 400 or 452 million, an increase of 42 to 60%, and the correction factor would fall further to 0.29 or 0.26. The impact assessment of the revision freezes activity at its 2023 level and assumes an economy shifting towards services: it assesses the reform as if European industry were not to regain the growth the Commission sets for it as an objective.

A conditionality that delays and weakens

From 2031, each installation would have to submit a decarbonisation investment plan. It would receive 80% of its allocation once the plan is approved, and the remaining 20% only after confirmation of its implementation, up to two years after the end of each five-year period. These 20% are also conditional on investments in the EU at least equal to the value of the whole allocation for the period, and on a significant reduction in emissions. Yet free allocation already acts as aid conditional on reductions: an installation that reduces nothing gains nothing from it, and the transfer of value helps it invest only if that investment lowers its emissions. The European Parliament's rapporteur proposes applying these conditions to a third of the allocation in 2031, then to all of it in 2035.

For European industry, the conditional share of these allowances would be worth, under the Commission's proposal, 30 billion euros over the decade, at a price of 150 euros (the impact assessment's assumption). The delay in its payment alone would cost 2.5 to 5.7 billion euros, and each installation would bear the risk of losing its share of free allowances according to criteria, unknown today, that a delegated act will set. A final clause requires the allowances received to be repaid in the event of relocation, with no time limit. Finally, the cost of the related administrative formalities, minor as it may seem compared with the amounts at stake, is also underestimated: the impact assessment puts it at 8 million euros for the whole EU, whereas a plausible order of magnitude, including the verification and approval of plans, is 72 to 138 million over the phase.

These conditions would add to those that already govern compensation for indirect carbon costs in electricity prices (an electro-intensive installation would maintain two plans for two forms of aid that address the same risk). This compensation is itself uncertain: France extended it to the newly eligible sectors only for 2025 costs, and the draft 2027 budget provides an amount for 2026 costs without mentioning its renewal for these sectors.

Other possible ways of sharing the same cap

Yet the proposed cap leaves other choices open. Splitting the available quantity equally between auctions and free allocation would give free allocation 31% of the loosening (against 23% in the proposal), and the correction factor would be 0.45 in 2040 instead of 0.40. An allocation that fully served the allowances calculated on the benchmarks, without a correction factor, would even fit within the proposed cap at constant activity (at the cost of a significant reduction in auctions). Such a transfer would no longer fit within the envelope in 2040 if international credits were unavailable.

These ways of sharing a cap that tends towards zero in the long run do not fully address the underlying problem: a carbon price that European industry's competitors do not pay.

High-quality international credits would address it better. The proposal reserves their purchase for a centra-

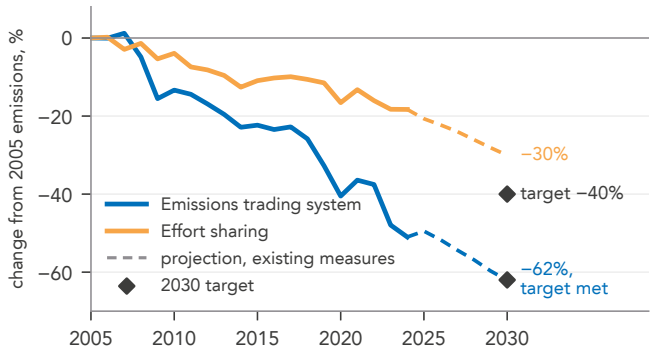
lised mechanism, endowed with 260 million allowances over 2036-2040, and makes their availability a variable of the cap: without them, the 2040 cap would fall from 394 to 292 million allowances and the correction factor to 0.25. A company deciding on an investment today will therefore not know before 2033, the date of the report the Commission must deliver on these credits, which cap trajectory will apply after 2036. The European Parliament's rapporteur removes this fallback, without opening these credits to installations. Their direct use by installations, within a limit and with quality criteria to be defined, would finance reductions where they cost least and narrow the gap in prices and contributions between Europe and the rest of the world.

The risk of additional effort shifted onto the emissions trading system

The proposed revision covers only part of the EU's climate objective: a 90% reduction in net emissions by 2040 compared with 1990 and climate neutrality in 2050. Outside the emissions trading system, emissions from road transport, buildings, agriculture, waste and small industry fall under effort sharing between Member States. This is where the gap to the 2030 target lies: with existing measures, these emissions would fall by 30% from 2005, against a target of 40%, while those of the emissions trading system would meet theirs, -62% (chart 3). Between the 2020 target, -10%, and the 2030 target, emissions outside the emissions trading system had covered by 2024 only slightly more than a quarter of the way.

Additional ambition has so far fallen more heavily on the emissions trading system: when the EU raised its 2030 target in 2023, the reduction sought went from 43 to 62% for the sectors under the system and from 30 to 40% for those under effort sharing. Channels for shifting the effort exist. Nine Member States can already cancel auctioned ETS allowances to cover emissions outside the system, and the European Climate Law calls for "enhanced flexibility within and across sectors and instruments" after 2030. The gap to be closed by the sectors outside the emissions trading system in 2030, around 250 million tonnes, is close to two thirds of the cap of the sectors under the system in 2040: every hundred million allowances removed from the 2036-2040 cap would lower the 2040 correction factor by about 0.05.

Chart 3. The emissions trading system meets its 2030 target, effort sharing does not



EU-27; 2025 projections. Sources: European Environment Agency, EU Registry, Rexecode calculations.

ETS2, the trading system that is to cover fuels used in buildings, road transport and small industry from 2028, opens another channel through which the missing effort could fall back on the sectors currently in the system (see our Repères No. 18). It will cover a large part of the effort-sharing sectors, in a separate market, with its own cap and a price-moderation mechanism that releases only limited volumes of allowances, so its effect on the price remains uncertain. The revision excludes it from its scope, but provides for an assessment by 2031 of integrating its sectors into the current system. Aviation offers the precedent: it has its own cap, but since 2021 its allowances and those of installations can be surrendered interchangeably. If the two markets were brought together in the same way, buildings and transport, whose emissions are falling much more slowly, would buy allowances on the common cap and push up the price paid by industry, with nothing in the current reform to contain it.

Yet post-2030 targets for the sectors outside the system are expected to be proposed only at the end of 2026, when the Council and the Parliament adopt their positions on this reform. The European Climate Law already requires, for carbon removals alone, that possible shortfalls "would not be at the expense of other economic sectors". Extending this principle to post-2030 national targets would guarantee the sectors under the emissions trading system that shortfalls elsewhere will not be shifted onto them, and would support industrial investment through the predictability the proposed revision promises without delivering.

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