ETS Reform: Free Allocation in Return for Investment Obligations, and New Participants

On 17 July 2026, the European Commission published its proposal to reform the emissions trading system (COM(2026) 616 final), announced as relief for industry.

At the heart of the reform is relief in free allocation. In return, free allocation is tied to investment obligations. Parts of industry already criticise this as a devaluation of free allocation. On the other side, the relief in free allocation and in the volume of allowances is read as a retreat from the climate target and a wrong signal to first movers. It is therefore worth taking a closer look at what is actually known so far and what conclusions companies can draw.

The proposal also further develops the rules on the use of CO_2 (carbon capture and utilisation, "CCU"), which brings additional companies into the ETS, from waste incineration and CO_2 transport to manufacturers that bind CO_2 into products.

Fast-acting: the benchmark revision

Alongside the actual reform proposal, the Commission has proposed a revision of the fallback benchmarks for free allocation, that is, the calculation values based on heat and fuel consumption. For the period 2026 to 2030, it is expected to bring industry additional free allocation worth around 6 billion euros.

The revision is running in an accelerated procedure outside the main reform and is intended to take effect within the current trading period. No obligation in return (see below) is attached to it.

Long-term relief

The core of the reform concerns the period from 2031 and contains several elements intended to lower ETS costs for industry:

- Free allocation for the CBAM sectors (including steel, cement, aluminium, fertilisers and hydrogen) runs four years longer than previously planned. Under current law, free allocation is to be phased out in parallel with the ramp-up of the CBAM and end in 2034. The proposal has it phase out more slowly from 2028 and stretches the phase-out path to the end of 2037. The full transition to the CBAM is postponed accordingly.
- The total number of allowances falls more slowly. The linear reduction factor is to be 3.7 percent for 2031 to 2035 and 1.7 percent from 2036, compared with 4.3 percent at present (4.4 percent from 2028 under current law). Under the current legal position, no new allowances would be issued from around 2039; with the flattened path, issuance continues into the 2040s. The 1.7 percent figure from 2036, however, depends on whether the EU's plans to purchase international credits itself can be implemented. If not, the factor rises to 2.7 percent from 2036.

- Fewer surpluses are absorbed. The Market Stability Reserve is loosened. The intake rate for surplus volumes is to fall from 24 to 12 percent; under the amendment proposal already presented in April, allowances in the reserve are moreover no longer to be cancelled but held as a buffer.
- Funding is to become accessible more quickly. The Industrial Decarbonisation Bank is to be established from 2028 and operate in two phases. In the first phase, 2028 to 2031, the ETS Investment Booster allocates 400 million allowances as fixed CO_2 premiums on a first-come, first-served basis, paid out against independently verified emission reductions; a share is reserved for lower-income Member States. From 2031, a second phase follows with competitive procedures, in particular carbon contracts for difference; in total, 100 billion euros are to be mobilised for industrial decarbonisation.
- More ETS revenue is to flow back to industry through national funding programmes. Member States are to direct at least 50 percent of their auction revenues into defined priority areas, including industrial decarbonisation, clean energy and grids. According to the Commission, only around 5 percent of revenues currently flow directly into industrial decarbonisation.

Which obligations are coming?

From 2031, free allocation is to depend on obligations in return. This is an idea already familiar from other instruments such as the industrial electricity price, indirect cost compensation (Strompreiskompensation) or the special equalisation scheme (Besondere Ausgleichsregelung), and one that originates in EU legislation.

To receive any free allowances at all from 2031, the operator must submit a verified decarbonisation investment plan. 80 percent of the allowances are issued once the plan has been approved; the remaining 20 percent only when, at the end of the respective five-year period, investments to reduce the installation's emissions equal to the economic value of the allocation have been made and actual emission reductions have been demonstrated.

This creates new tasks for companies:

- A measures and investment plan must be drawn up, verified by one of the familiar ETS verifiers and approved by the competent national authority (in Germany, the DEHSt). It must also be published.
- Implementation of the investment plan must then be demonstrated no later than two years after the end of the five-year period in order to receive the withheld 20 percent of free allowances: investments at least equal to the economic value of the free allocation, and significant emission reductions at installation level.
- Anyone relocating production out of the EU is to be required to return all allowances already received (including the 80 percent already allocated).
- The new funding from the Investment Booster is also to be performance-based. Payouts are to be tied to independently verified emission reductions, with strict completion deadlines and completion bonds; in the competitive procedures from 2031, bid bonds are added.

How hard are the obligations really?

The obligation to invest 100 percent of the value of free allocation places a burden on free allocation in its entirety, an instrument that was introduced to preserve the competitiveness of European industry.

The concern in parts of industry that this instrument is being hollowed out is therefore not unfounded. Nevertheless, a closer look at the design envisaged so far is worthwhile:

- The decisive parameters of the investment obligation are not yet in the draft. Which costs count as eligible decarbonisation investments, and how the economic value of the allocation is determined, are to be laid down by the Commission only in delegated acts, in close cooperation with industry (recital 46). There is still room here for a design that takes industry's interests into account. What is certain is that both capital expenditure (CAPEX) and operating expenditure (OPEX) will expressly count as investments. Ongoing additional costs of decarbonised operation can therefore contribute to meeting the required volume; the precise criteria will follow in the delegated acts.
- As things stand, there is no mechanism for repaying the 80 percent received if the investment plan is not implemented, for example because of unforeseen changes in the market. The exception, naturally, is the case of false statements in the application. The risk of non-implementation is therefore limited to the 20 percent initially withheld. Indirectly, however, a failure has continuing effect: the plan contains interim targets (the first on 31 December 2035), and each new five-year period requires an approved plan that credibly sets out decarbonisation by 2050.
- A genuine repayment obligation is envisaged where production is relocated outside the EU: anyone who has received the 80 percent and then relocates production capacity or the associated economic activity, in whole or in part, out of the EU must repay the allowances received for the period.
- At the same time, the draft contains exceptions and relief. The 10 percent most efficient installations in a sector, as well as zero- and low-emission installations, are exempt from the plan and investment obligation. Anyone implementing a funded project from the Investment Booster, the Industrial Decarbonisation Bank or the Innovation Fund at the installation needs no separate plan and no additional verification. And operators can form pools with other operators and installations in order to meet the investment requirements of several installations jointly.

The specific design will also determine whether the ETS reform will truly provide relief that strengthens competitiveness, or whether it is rather a funding programme for decarbonisation measures. Factoring the value of free allocation into the product price becomes harder if that value has to be invested at the same time. It is also clear that the investment obligation affects only EU producers. Under the CBAM Regulation, importers owe only emissions reporting and CBAM certificates for the share no longer covered by free allocation; the CBAM mechanism knows no investment obligation. On the other hand, the Commission must, alongside the primary goal of climate protection, also protect so-called first movers, for example in the use of green hydrogen or carbon capture and storage, by not depriving them of the advantage of lower CO_2 costs over their less decarbonised competitors.

What does this mean for planning?

The investment plan thus becomes the central document. It secures the allocation and is at the same time the natural point of reference for financing the same measures, for instance through the Investment Booster and later the carbon contracts for difference of the Industrial Decarbonisation Bank. These instruments meet existing relief measures such as indirect cost compensation ("SPK"). Under the proposal, that too is to be continued beyond 2030. Where several instruments touch the same measures or the same costs, the State aid cumulation rules must be observed. This is already apparent today with the industrial electricity price ("ISP") and the SPK.

Overall, companies face additional work, both in drawing up and evidencing the investment plans and in the actual application for and administration of the funding instruments. The option of pooling and the burdening of free allocation with investment obligations also make coordination within supply chains necessary to an even greater extent, as with the treatment of indirect electricity costs under the ISP and the SPK.

Finally, it is important for assessing the investment obligation that its decisive parameters are not yet in the text of the Directive at all. It is at that level that the practical cost of conditionality will be decided, for instance which operating costs are eligible in detail. Here, the perspective and practical experience of the companies affected can be fed in through associations and consultations.

What else is in it? CCU – waste incineration – RFNBO

- The incineration of non-hazardous municipal waste is newly brought into the ETS, in stages from 2031.
- Waste incineration is also the key to new CCU rules. Where captured CO_2 is bound into products whose carbon is later released again, allowances are no longer to be surrendered at the start but only at the end of the chain, in effect by the waste incineration plant, which pays for all fossil carbon in its waste. As before, no surrender obligation arises in the case of permanent chemical binding or storage (CCS). In the case of direct use without chemical binding, for instance as carbonic acid in beverages, the direct surrender obligation remains at the source of the emission, or in future probably at the capture plant.
- Consistently, the entire CCU chain itself is brought into the ETS from 2031. Anyone who captures CO_2 from an ETS installation, processes it, liquefies it, chemically binds it into products or transports it between ETS installations will in future need an emissions permit and must report. New industries will thus fall under the ETS, such as manufacturers of CO_2-cured concrete products and carbonated aggregates, PCC precipitation plants at paper mills, or methanol and polymer plants that bind purchased CO_2. For these companies, however, this is likely to mean primarily reporting obligations and allowance costs for their own process losses, since the main emissions arise at the waste incineration plant.
- For e-fuels and other electricity-based fuels (RFNBOs), the distribution of fuels will in future be included in the ETS as a new activity. CO_2 from the atmosphere or from emission-free sources is expressly assigned an emission factor of zero.

As shown, there is a great deal in the Commission's proposal. The European Parliament and the Council still have to agree; the first quarter of 2027 has been named as the target for reaching agreement. Changes in detail are to be expected in the negotiations, but the basic guardrails are set. Much will depend on the specific design in the delegated acts.

What is unlikely to change fundamentally is the relief coupled with investment obligations. The further development of the CCU chain and the inclusion of new activities related to the processing, treatment, interim storage and transport of CO_2 will also come. Companies can and should therefore prepare now and, in particular when concluding new long-term contracts, take into account the investment obligations attached to free allocation and the future ETS obligation for certain activities.

I am continuing to follow and report on this topic and welcome an exchange of views.

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