A&O SHEARMAN

The revision of the EU Emissions Trading System

JULY 23, 2026

Executive Summary

The Commission has published its proposal to review Directive 2003/87/EC (**the EU ETS Directive**) under the title "*proposal for a directive amending Directive 2003/87/EC and Decision (EU) 2015/1814 as regards driving competitiveness and cost-effective decarbonisation*" [1], with document reference 2026/0212 (COD).

The key elements of the proposal are:

1) alignment of the ETS cap with the 2040 climate target by reducing the linear reduction factor (**LRF**) to 3.7% for 2031–2035 and 1.7% for 2036–2040, allowing continued issuance of allowances into the 2040s;
2) the introduction of a mechanism under which up to 260 million allowances may be set aside for the Commission by which the Commission may fund its purchase of up to 260 Mt of high-quality, high-integrity international credits, contributing to ETS-sector ambition from 2036 to 2040, while complementing domestic action and resulting in a domestic reduction target of -85% compared to 1990;

[1] Available here: https://ec.europa.eu/commission/presscorner/detail/en/ip_26_1596.

3) integration of 250 Mt of domestic permanent carbon removals (BioCCS and DACCS) into the ETS through a Commission purchasing programme, whereby the cap of allowances will be increased by 250 million allowances for auctioning between 2031 and 2040 (with an additional 10 million allowances if the revenues of the aforementioned 250 million auctioned allowances would prove insufficient);
4) reform of the Market Stability Reserve, including a reduction of the intake rate from 24% to 12% and the introduction of dynamic, annually declining parameters;
5) extension of benchmark-based free allocation beyond 2030, with continued support conditional from 2031 on operators establishing verified 'Invest in EU Decarbonisation Plans' and investing the equivalent of 100% of their free allocation value in decarbonisation in the EU;
6) a slower phase-out of free allocation for sectors covered by the Carbon Border Adjustment Mechanism (**CBAM**),[2] now extended to 2038, but subject to conditions such as adhering to a decarbonisation plan;
7) establishment of the Industrial Decarbonisation Bank (IDB) with an estimated EUR 100 billion in funding, whose first phase is the ETS Investment Booster, providing approximately EUR 30 billion in support through 400 million allowances for 2028-2030, followed from 2031 by a second phase deploying a further 400 million allowances through competitive bidding;
8) extension of the EU ETS geographic scope for aviation from 2029 to flights departing from the EEA and landing at aerodromes in third countries no further than 5,000 km from Frankfurt, as the largest aerodrome in the geographical centre of the Union, with a CORSIA deduction mechanism;
9) extension of the maritime ETS to certain categories of smaller ships (below 5,000 GT but not below 400 GT) and establishment of a Sustainable Maritime Alternative Propulsion (SMAP) mechanism; and
10) inclusion of municipal waste incineration from 2031 with a phased surrender obligation reaching 100% in 2034.

Importantly, the Commission limited its proposals to ETS1 and does not intend to amend ETS2. As described in the proposal, ETS2 is excluded from the scope of this proposal as it will become fully operational in 2028, its application is due for review by 2029, and any assessment of the feasibility of integrating the sectors under ETS2 into the EU ETS is due by 2031.

The ETS review is being negotiated against a backdrop of heightened concern over industrial competitiveness, energy prices and the cost of decarbonisation. The Irish presidency of the Council has indicated that it plans to rapidly move forward, with a view to reach a Council negotiating position in time for a meeting of environment ministers in mid-December, stressing that certainty on the ETS is vital for European competitiveness.[3] Market participants should expect continued political pressure on core parameters, including free allocation, CBAM timing, price-stability tools and sectoral scope.

1. What Is the EU Emissions Trading System?

The EU Emissions Trading System (EU ETS) is the world's first major cap-and-trade carbon market. Launched in 2005, it covers electricity and heat generation, energy-intensive industry, commercial aviation, and (since 2024) maritime transport, together accounting for approximately 40% of total EU GHG emissions. Now in its fourth trading phase (2021-2030), it is governed by Directive 2003/87/EC[4] as most recently amended and has been linked to the Swiss ETS since 2020.[5] Separately, the EU and UK are negotiating linkage of their emissions trading systems. By 2025, covered-sector emissions had been reduced by more than half compared to 2005 levels.[6]

---

[2] Established by Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism.
[3] https://www.endseurope.com/article/1965364/ireland-kicks-off-talks-ets-hope-deal-year-end
[4] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading, as amended (consolidated version of 5 June 2023), Article 9.
[5] Agreement between the European Union and the Swiss Confederation on the linking of their greenhouse gas emissions trading systems, OJ L 322, 7.12.2017.
[6] European Parliamentary Research Service (EPRS), Briefing: "Free allocation in the EU emissions trading system," PE 789.377, July 2026, p. 1.

2. Proposed amendments to the EU ETS

On 17 July 2026, the Commission published its proposal for amendments to the EU ETS. The proposed amendments by the Commission cover a broad area of topics of the EU ETS. Below, we provide an overview of the key changes proposed by the Commission and how they affect the current ETS rules.

2.1 CAP TRAJECTORY AND THE LINEAR REDUCTION FACTOR

a. Current framework

Article 9 of the ETS Directive provides that the Union-wide quantity of allowances must decrease linearly each year. The current LRF is 4.3% per annum from 2024 to 2027, increasing to 4.4% from 2028[7]. At this trajectory, total ETS1 allowance supply is expected to approach zero around 2039 or the early 2040s, raising questions about alignment with the 2040 target of a 90% net GHG reduction, provision for residual hard-to-abate emissions, and market functioning as supply diminishes.[8] The European Climate Law requires the Commission to address these issues but leaves the post-2030 LRF to be determined in the current proposal.[9]

b. Commission Proposal

The Commission proposes to amend Article 9 of the ETS Directive to set the linear reduction factor at 3.7% from 2031 to 2035 and 1.7% from 2036 to 2040. This replaces the current rate of 4.3% (rising to 4.4% from 2028) and allows the continued issuance of allowances into the 2040s, avoiding a trajectory that would have driven the cap to zero around 2039-2040.

The revised trajectory is designed to be aligned with an EU-wide domestic ambition of -90% for the period 2031–2035 and -85% from 2036 to 2040, reflecting the European Climate Law's provision permitting up to 5 percentage points of international credits from 2036. A proposed new Article 9b provides for allowances to be set aside for the purchase of 260 Mt of high-quality international credits (see further below).

A fallback mechanism is included: if the Commission reports by 31 January 2033 that high-quality, cost-effective international credits are not available, the LRF reverts to 2.7% from 2036, aligning the trajectory with a fully domestic 90% reduction.

2.2 INTERNATIONAL CARBON CREDITS AND ARTICLE 6

a. Current framework

The EU ETS is an allowance-based system in which international carbon credits are not currently recognised as compliance units. In Phases 2 and 3 (2008–2020), Kyoto Protocol credits could be used or exchanged within quantitative and qualitative limits,[10] covering roughly 1.6 billion tonnes of CO_2-equivalent (a factor the Commission identified as contributing to the allowance surplus that depressed prices). Article 6 of the Paris Agreement now provides the framework for international carbon-market cooperation, and the amended 2040 Climate Law permits high-quality international credits to contribute up to 5% of the EU's 90% net-reduction target, but this operates at the EU target level rather than as an operator-level ETS compliance right. The debate has accordingly been reopened on whether Article 6 credits should be admitted for ETS compliance.

[7] Directive 2003/87/EC, Article 9, as amended by Directive (EU) 2023/959. LRF of 4.3% from 2024-2027 and 4.4% from 2028.
[8] EPRS Briefing PE 782.615, 2026; see also EPRS Briefing PE 785.707, 2026.
[9] Amended Regulation (EU) 2021/1119 (European Climate Law).
[10] Kyoto Protocol, Articles 6 and 12; Commission Regulation (EU) No 389/2013, Articles 59-61.

b. Commission Proposal

The proposal does not introduce international carbon credits as a direct operator-level compliance unit within the EU ETS. Operators remain required to surrender EU allowances for their covered emissions. Instead, the proposal operationalises the European Climate Law's 5% flexibility at the EU ETS' system level: a new Article 9b provides for 260 Mt of allowances to be set aside between 2036 and 2040 for the Commission to fund the purchase of high-quality international credits meeting criteria to be established in separate Union legislation. The resulting additional emission space is reflected in the lower LRF of 1.7% from 2036. A pilot period in 2031–2035 may be considered.

The Commission would have to report by 31 January 2033 on the development of a high-quality international credits market and their potential contribution to ETS-sector ambition. If such credits would not be not available on acceptable terms, the LRF would revert to 2.7% from 2036, aligning the EU ETS with a fully domestic 90% reduction.

2.3 CARBON REMOVALS AND CARBON CAPTURE AND UTILISATION (CCU)

a. Current framework

Article 30(5)(a) of the ETS Directive mandates the Commission to report by 31 July 2026 on how negative emissions from GHG removals could be accounted for and covered by the EU ETS, subject to safeguards ensuring removals do not displace necessary emissions reductions.[11] Article 30(5)(c) requires a related assessment of carbon capture and utilisation (**CCU**) falling outside the permanent chemical binding exemption under Article 12(3b).[12] Under the current framework, captured emissions avoid surrender only if permanently geologically stored or permanently chemically bound in a product.[13] The key question for the Commission was how to integrate removals, such as direct air capture with storage or bioenergy CCS, without weakening the incentive to reduce emissions at source; the amended European Climate Law points to a role for domestic permanent removals in the EU ETS for residual hard-to-abate emissions.[14]

b. Commission Proposal

The proposal introduces a new Article 9c increasing the ETS cap by 250 million allowances, assigned to the Commission for the purchase of an equivalent quantity of domestic permanent carbon removal units generated by BioCCS and DACCS activities certified under the Carbon Removal Certification Framework (**CRCF**). An additional 10 million allowances are available to cover any shortfall in financing. The LRF does not apply to this increase. Purchased removal units would be cancelled in the Union Registry; the net ETS target is gross emissions minus the purchased removals. Allowances not auctioned for this purpose before 2041 return to the cap.

To facilitate operators' own use of removals, the proposal allows operators, shipping companies and aircraft operators to compensate their own fossil emissions with CRCF-certified BioCCS removals they themselves generate (new Article 14(1a)). This compensation cannot generate negative emissions or allowances and triggers a corresponding reduction in the Commission's purchasing obligation. The Commission must report by 31 December 2034 on progress, including the feasibility of gradually transitioning from public-authority integration toward direct operator integration beyond own use.

---

[11] Directive 2003/87/EC, Article 30(5)(a), as inserted by Directive (EU) 2023/959.

[12] Directive 2003/87/EC, Article 30(5)(c), as inserted by Directive (EU) 2023/959.

[13] See ETS Directive, Article 12(3a), which provides that no obligation to surrender allowances arises for emissions captured and transported for permanent storage under Directive 2009/31/EC; Annex I, which brings capture, transport and geological storage of greenhouse gases within the scope of covered activities; and Article 12(3b), which provides a separate exemption for GHGs captured and utilised where they are permanently chemically bound in a product and do not enter the atmosphere under normal use, including end-of-life activity.

[14] Regulation (EU) 2021/1119, as amended by Regulation (EU) 2026/667, including the requirement for post-2030 legislative proposals to reflect the role of domestic permanent removals in the EU ETS for residual hard-to-abate emissions; see also EPRS Briefing PE 785.707, 2026, on potential integration models.

On CCU, the inclusion of waste incineration in the ETS enables a shift in the point of accounting for non-permanently captured CO2: the surrender obligation is deferred downstream to the point at which CO2 is re-emitted in an ETS-covered process. For synthetic fuels (e-fuels), accounting is placed midstream at the point of distribution. This avoids the current disadvantage under which captured CO2 used in non-permanent products faces an upstream surrender obligation that does not apply to equivalent fossil-based products.

2.4 CARBON PRICE VOLATILITY AND THE MARKET STABILITY RESERVE

a. Current framework

The Market Stability Reserve (**MSR**), established by Decision (EU) 2015/1814, addresses structural imbalances in allowance supply by automatically adjusting auction volumes based on the Total Number of Allowances in Circulation (**TNAC**). By end-2024, approximately 3.2 billion allowances in the MSR had been invalidated, removing them from the system.[15]

The European Council's March 2026 conclusions called on the Commission to reduce the volatility of the carbon price and mitigate its impact on electricity prices.[16] The Commission had confirmed that it would address this objective primarily through reform of the MSR rather than through direct price controls, addressing volatility as part of broader MSR reform to enhance the reserve's "firepower."[17] The two principal instruments are therefore the MSR itself, which reacts to allowance supply, and the price-based trigger under Article 29a of the ETS Directive, which draws on the reserve.

On 1 April 2026, the Commission proposed a targeted MSR amendment to cease this invalidation mechanism, instead retaining the excess as a buffer to moderate price spikes.[18] The broader revision was also expected to address the MSR's core operating parameters, including the intake rate and thresholds.[19] Separately, Article 29a of the ETS Directive provides a price-based mechanism under which 75 million allowances are released from the MSR if the average allowance price exceeds 2.4 times the two-year average for six consecutive months, though in practice this trigger has never been activated.[20]

b. Commission Proposal

The proposal introduces an integrated package of MSR reforms to make the MSR parameters dynamic over time. This is to take account of a shrinking cap and ensure that the reserve remains resilient to maintain liquidity. The intake rate is reduced from 24% to 12% from 2028, meaning future intakes in periods of surplus are spread over a longer period. As a consequence, the upper buffer threshold is adjusted downwards to 947 million allowances. The upper and lower thresholds, the corresponding buffers, and the fixed release quantity are made dynamic: each declines by a fixed 4% per year from 2029, tracking the shrinking market. A new lower buffer of 300 million allowances is introduced from 2028; when the TNAC falls between the lower threshold (400 million) and the lower buffer, releases are proportionate rather than fixed. The calculation of the TNAC is also amended to include cumulative net aviation demand from 2012 to 2023, reducing it by 173 million allowances and making the MSR more responsive.

These changes build on the April 2026 proposal (COM(2026) 153) to cease the invalidation mechanism, retaining allowances in the reserve as a deployable buffer. No hard price cap or discretionary intervention mechanism is introduced.

---

[15] European Commission, *EU reinforces the stability and predictability of its carbon market*, Press Release IP/26/666, 1 April 2026.
[16] European Council conclusions, 19 March 2026.
[17] European Commission, "Questions and answers on the EU ETS Market Stability Reserve", QANDA/26/667, 1 April 2026; Statement by President von der Leyen at the March 2026 European Council, STATEMENT/26/663.
[18] European Commission, Proposal for a Decision amending Decision (EU) 2015/1814 as regards ceasing the invalidation of allowances in the market stability reserve, COM(2026) 153 final, 1 April 2026.
[19] EPRS Briefing PE 782.615, 2026.
[20] Directive 2003/87/EC, Article 29a.

2.5 CARBON LEAKAGE, BENCHMARKS, AND FREE ALLOCATION

a. Current framework

Article 10a of the ETS Directive establishes the framework for transitional harmonised free allocation.[21] Free allocation remains available for eligible industrial installations, differentiated by carbon-leakage exposure and benchmark performance: highly exposed sectors receive up to 100% of benchmark through 2030, while less exposed sectors see a declining share reaching zero in 2030. A separate CBAM factor reduces free allocation for CBAM goods from 97.5% in 2026 to zero in 2034.[22] Allocation is calculated by reference to 52 product benchmarks (plus heat and fuel fallbacks) reflecting the emission intensity of the 10% most efficient sub-installations, whereby only the best-performing installations which meet or exceed their respective benchmarks receive enough free allowances to cover their emissions, while less efficient installations must purchase the balance on the market.[23] Updated benchmark values for 2026–2030, adopted on 29 June 2026, are expected to reduce free allocation by more than 16% on average compared with 2021, with heat and fuel fallbacks recording the largest reductions (~34% each). The Commission also indicated that the ETS revision would consider sector-specific fallback benchmarks for sectors where the current product-benchmark approach may not adequately reflect decarbonisation pathways.[24]

A recent amendment to the EU ETS Directive (Directive (EU) 2023/959) already effected the revision of the EU ETS legislative framework by introducing conditionalities for free allocation linked to the implementation of energy efficiency recommendations from energy audits, and obligations to establish climate neutrality plans for district heating and for the 20% least efficient installations under each ETS product benchmark. However, civil society organisations have urged the Commission to make all free allowances conditional on further decarbonisation.

b. Commission Proposal

The proposal extends benchmark-based free allocation for non-CBAM sectors through the 2031-2035 and 2036-2040 allocation periods, but from 2031 makes it conditional on an independently verified “Invest in EU Decarbonisation Plan” and EU decarbonisation investments equal to at least 100% of the economic value of the free allocation received for the relevant five-year period. Once the plan is verified by an ETS verifier and approved by the competent authority, 80% of the allocation would be released in annual tranches. The remaining 20% would be withheld until the competent authority confirms, no later than two years after the period ends, that the investments were implemented in the EU, eligible CAPEX and OPEX equalled at least 100% of the free-allocation value, and annual emissions reports show significant installation-level emissions reductions. The mechanism is designed to redirect free allowances toward industrial decarbonisation in Europe, but it adds verification, approval and *ex post* compliance steps that are likely to draw pushback over administrative burden, timing risk and uncertainty around the detailed eligibility rules, which the Commission would further specify by delegated acts.

The investment conditionality does not apply universally. The proposal exempts the following categories: (i) the 10% most efficient installations (those setting the revised benchmark values in each sector or subsector); (ii) zero-emission or low-carbon installations (to be defined by delegated act); (iii) installations in which a project selected for support under the IDB, Investment Booster or Innovation Fund is being implemented during the relevant five-year period; and (iv) small installations that remain voluntarily within the EU ETS. In addition, operators may fulfil the investment requirement collectively through a ‘joint decarbonisation investment agreement’ (pooling), provided the agreement covers at least one full five-year allocation period and the pooled investment volume corresponds to at least 100% of aggregate free allocation value across all participating installations.

---

[21] Directive 2003/87/EC, Article 10a(1): "The Commission shall adopt implementing acts [...] for transitional Union-wide rules for the harmonised free allocation of allowances."
[22] Directive 2003/87/EC, Article 10a; European Commission, *Guidance Document No. 1 on the harmonised free allocation methodology for the EU ETS post-2020*, Table 7 and Table 8; European Commission, “Carbon leakage” and “About free allocation.”
[23] EPRS, Briefing: “Free allocation in the EU emissions trading system,” PE 789.377, July 2026, pp. 3-4 and 7; updated benchmark values for 2026-2030 adopted and published in the Official Journal on 29 June 2026 (Commission Implementing Regulation (EU) 2026/1412).
[24] EPRS Briefing PE 785.707, 2026.

To further incentivise long-term investment within the EU, the proposal introduces an anti-relocation mechanism: operators that receive free allocation under the investment conditionality regime and subsequently relocate or transfer their relevant production activities outside the Union would be required to reimburse the allowances received for the relevant allocation period. In the absence of reimbursement, the Member State would deduct free allowances in subsequent years.

District heating installations remain eligible for free allocation but on a declining trajectory: allocation decreases by equal amounts from 2030, reaching zero by 2040.

For CBAM sectors, 15% of the free allocation previously phased out under the CBAM factor is reintroduced from 2028, slowing the phase-out and extending it to 2038. The Commission's stated rationale is to address residual leakage risk for CBAM sectors during the transition, which extending the new investment- conditionality regime to these sectors from 2031. Sectors not covered by CBAM but exposed to carbon leakage remain eligible for up to 100% benchmark-based free allocation. The proposal also includes an empowering provision for the Commission to establish sector-specific heat and fuel fallback benchmarks, and a separate targeted proposal (COM(2026) 619) increases free allocation under the existing fallback benchmarks by approximately EUR 6 billion for 2026–2030.

2.6 REVENUE USE AND THE ETS INVESTMENT BOOSTER

a. Current framework

ETS auction revenue has become a major source of climate finance, with EUR 24.4 billion directed to Member State budgets and EUR 8.6 billion to the Innovation Fund and Modernisation Fund in 2024.[25] However, Commission reporting indicates that only around 5% of the 2024 revenues disbursed by Member States for Article 10(3) purposes was directed to industry decarbonisation.[26] The Commission had proposed a EUR 30 billion "ETS Investment Booster," (phase I of the IDB as defined below) financed by the monetisation of 400 million ETS allowances, focused on lower-income Member States, alongside tightened transparency requirements on revenue use.

b. Commission Proposal

The proposal establishes the Industrial Decarbonisation Bank (**IDB**) in two phases (Article 10cc). The first phase, the Investment Booster (new Article 10cd), reserves 400 million allowances for 2028-2030 to support industrial decarbonisation on a first-in-first-served basis using fixed carbon premia. A dedicated share (100 million allowances initially, reducing to 60 million after 18 months) is reserved for projects in lower-income Member States. From 2031, the IDB's second phase (Article 10ce) deploys a further 400 million allowances through competitive bidding, awarding Carbon Contracts for Difference or carbon premia for up to 10 years.

The Innovation Fund is continued with 200 million allowances for innovative first-of-a-kind technologies. The Modernisation Fund is extended and its eligibility criteria updated to include electrification, industrial decarbonisation and CCS/CCU, while continued support for fossil-fuel based energy generation remains excluded. The proposal strengthens requirements on Member States' use of auction revenues: Member States would be required to allocate at least 50% of their ETS revenues to specified priority purposes focused on the decarbonisation of ETS sectors (including industrial decarbonisation, clean energies and grids, low-carbon transport, and waste management decarbonisation). Mandatory visibility requirements are also introduced, obliging Member States to publicly communicate the origin of ETS-funded measures using a standardised EU label. These

[25] European Commission, "How do Member States use ETS revenues?"; see also EPRS, "Revision of the EU emissions trading system," PE 782.615, January 2026.
[26] See European Commission, "Emissions Trading - Putting a Price on Carbon", Questions & Answers, Q7 (July 14, 2021; European Commission, DG Climate Action, "How do Member States use ETS revenues", (cited above).

provisions will be complemented by amendments to the Governance Regulation requiring integration of planned ETS revenue use into National Energy and Climate Plans.

2.7 SCOPE EXPANSION: AVIATION

a. Current framework

Aviation has been covered by the EU ETS since 2012, currently applying to intra-EEA flights and flights departing the EEA to Switzerland and the UK, with full auctioning from 2026 and 20 million allowances reserved over 2024-2030 to support sustainable aviation fuel uptake. The treatment of extra-European flights is linked to CORSIA, ICAO's global carbon offsetting scheme, which is more limited in scope than a cap-and-trade system.[27] Article 28b required the Commission to publish by 1 July 2026 an assessment of CORSIA's environmental integrity; if that assessment finds CORSIA insufficiently strengthened, or that participating States represent less than 70% of international aviation emissions, the Commission may propose extending the EU ETS to departing extra-EEA flights from 2027, with deductions for CORSIA costs to avoid double charging. The Commission has not published a standalone report under Article 28b; rather, its assessment of CORSIA's environmental integrity is incorporated into the impact assessment accompanying the proposal (SWD(2026) 616). The proposal takes account of the Commission's finding that CORSIA has not been sufficiently strengthened and that participating States represent less than 70% of international aviation emissions.

b. Commission Proposal

The proposal would extend the geographic scope of the EU ETS for aviation from 1 January 2029 to 31 December 2032, subject to a 2032 review, to flights departing from EEA aerodromes and landing at third-country aerodromes within 5,000 kilometres of the aerodrome of Frankfurt, which the operative text uses as the reference point for the "largest aerodrome in the geographical centre of the Union" formulation. The extension would apply on a non-discriminatory basis to all airlines on covered routes, but proposed Article 28a(1) would preserve or introduce derogations for, among others, flights to and from listed least developed countries and small island developing states unless their GDP per capita equals or exceeds the EU average, flights from outermost regions, dependencies and territories to third countries other than the UK, Switzerland and Gibraltar, flights to third-country aerodromes more than 5,000 kilometres from Frankfurt, and flights to third-country aerodromes within that radius where annual emissions from EEA-departing flights are below 15,000 tonnes. Business aviation would also be brought further into scope by removing the current flight-number exemption and applying simplified emissions thresholds.

The proposal takes account of the Commission's assessment that CORSIA has not been strengthened sufficiently and that participating states represent less than 70% of international aviation emissions. To avoid double pricing, a deduction mechanism allows aircraft operators to reduce their ETS surrender obligation by the cost of CORSIA offsetting on relevant routes, extended until 2035. The cap is increased commensurately, with a further 110 million allowances reserved for ETS-funded support for sustainable aviation fuels, electrification and cost-effective contrail reduction until 2040. ETS support for SAF production is extended to all departing flights from 2029, covering 30% to 60% of the remaining price differential depending on fuel type (50% for advanced biofuels, 60% for renewable hydrogen and RFNBOs, and 30% for other eligible non-fossil fuels until end-2029), with 100% coverage at airports on small islands (below 10,000 km^2) and in outermost regions, and a 10 percentage-point uplift for fuels produced from EU-sourced feedstock.

[27] ICAO, Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA).

2.8 SCOPE EXPANSION: MARITIME TRANSPORT

a. Current framework

Maritime transport has been covered by the EU ETS since 1 January 2024, with 100% of intra-EU voyage emissions and 50% of international voyage emissions included; since 2026, methane (CH_4) and nitrous oxide (N_2O) are also captured.[28] Article 3gg requires the Commission to review this coverage if the IMO has not adopted a comparable global market-based measure by 2028,[29] including whether obligations should extend beyond 50% of international voyage emissions. Article 3gg(5) further requires a report by 31 December 2026 on the feasibility of extending coverage to ships below 5,000 gross tonnage.[30]

b. Commission Proposal

The proposal extends the maritime ETS to specific categories of smaller ships between 400 and 5,000 gross tonnages, including oil tankers, chemical tankers, gas carriers, LNG carriers, ro-pax ships and passenger ships. These categories account for approximately 15% of emissions from the current ETS maritime scope. A new Sustainable Maritime Alternative Propulsion (SMAP) mechanism (Article 3gaa) reserves 110 million allowances from 2028 to 2040 to support the uptake of sustainable maritime fuels and zero-emission propulsion technologies, covering 55% to 90% of the remaining price differential depending on the fuel type (55% for biogas and advanced biofuels, 80% for low-carbon hydrogen and low-carbon fuels, 90% for RFNBOs, and 90% for zero-emission propulsion technologies), with additional uplifts of 5 to 10 percentage points for island voyages, EU-produced fuels, and EU-built propulsion systems.

On the IMO trigger under Article 3gg, the proposal does not pre-empt the 2028 review but introduces a review clause providing for a deduction mechanism in the event the IMO adopts a global measure, allowing shipping companies to surrender fewer allowances to the extent their emissions are also priced under the IMO instrument. Existing derogations for ice-class ships, outermost regions and public service contracts are extended to 31 December 2035. The temporary redistribution mechanism under Article 3ga(3) is extended to 31 December 2038. Anti-evasion measures are strengthened, including a lowering of the container transhipment incidence threshold from 65% to 50% and new rules for vessels engaged in offshore operations.

2.9 SCOPE EXPANSION: MUNICIPAL WASTE INCINERATION AND SMALLER INSTALLATIONS

a. Current framework

Article 30(7) of the ETS Directive requires the Commission to assess the feasibility of including municipal waste incineration installations within the EU ETS, potentially from 2028, accompanied where appropriate by a legislative proposal.[31] Article 30(5)(b) mandates a parallel assessment of lowering the 20 MW total rated thermal input threshold that currently defines which combustion installations are covered. Municipal waste incineration currently falls outside the ETS in most Member States, and lowering the 20 MW threshold would bring smaller industrial and district heating installations into the system.[32]

b. Commission Proposal

The proposal extends the EU ETS to all non-hazardous waste incineration and co-incineration installations with a capacity exceeding 3 tonnes per hour (aligned with the Industrial Emissions Directive threshold) by adding this as a new, separate activity in Annex I.

---

[28] Directive 2003/87/EC, Chapter II (Articles 3ga-3gg), as inserted by Directive (EU) 2023/959.
[29] See supra, discussion of the one-year postponement of IMO Net-Zero Framework adoption.
[30] Directive 2003/87/EC, Article 3gg(5) (report on ships below 5,000 GT by 31 December 2026).
[31] Directive 2003/87/EC, Article 30(7), as inserted by Directive (EU) 2023/959.
[32] Directive 2003/87/EC, Article 30(5)(b), as inserted by Directive (EU) 2023/959.

A new Article 12a introduces a phased surrender obligation: 25% of verified emissions for 2031, 50% for 2032, 75% for 2033, and 100% from 2034. A temporary national opt-out is available until end-2035 for Member States meeting at least two of three conditions: an equivalent national carbon tax above the average ETS auction price; being on track for EU municipal waste recycling targets; and being on track for the 2035 landfill target. A separate derogation is available for installations in outermost regions until end-2035.

The cap is increased commensurately: 10.2 million allowances in 2031, 19.5 million in 2032, 28.1 million in 2033, and 36 million in 2034. Hazardous waste incineration remains excluded. Monitoring, reporting and verification for landfilling of non-hazardous waste is introduced for monitoring purposes, with a review clause (Article 30(9)) requiring the Commission to report by 31 December 2034 on the appropriateness of extending the ETS to landfill emissions.

The proposal does not lower the 20 MW thermal input threshold. The impact assessment concluded that most relevant emissions from smaller installations will be covered under ETS2 (operational from 2028), making the environmental gains from lowering the threshold in ETS1 disproportionate to the administrative burden.

3. Implications for the Carbon Border Adjustment Mechanism (CBAM)

3.1 CURRENT FRAMEWORK

After initially operating under an interim reporting-only phase, the CBAM, established by Regulation (EU) 2023/956, has entered its definitive phase on 1 January 2026.[33] CBAM requires certain importers to register as CBAM declarants and to surrender CBAM certificates, whose prices are linked to those of EU ETS allowances, for emissions embedded in their imported goods.

CBAM currently covers imports of cement, iron and steel, aluminium, fertilisers, electricity, and hydrogen. Its purpose is to prevent carbon leakage by requiring importers to purchase CBAM certificates reflecting the carbon price that EU producers pay under the ETS. The intent is that for those sectors covered by CBAM, free allowances under EU ETS will be gradually phased out and replaced by the phasing in of CBAM as the primary instrument to mitigate the risk of carbon leakage.

CBAM and free allocation under the ETS are designed as mirror images: as free allocation is phased out (removing the subsidy to EU producers), CBAM phases in (imposing an equivalent cost on importers). This relationship is codified in Article 10a(1a) of the ETS Directive, which provides that no free allocation must be given for production of goods listed in Annex I of the CBAM Regulation, subject to the transitional CBAM factor.[34]

The CBAM factor schedule provides for a gradual reduction: 97.5% free allocation in 2026, 95% in 2027, 90% in 2028, 77.5% in 2029, 51.5% in 2030, 39% in 2031, 26.5% in 2032, 14% in 2033, and zero from 2034.[35] Any change to this schedule, including the extension of free allocation beyond 2034 announced by Commission President von der Leyen, would necessarily delay the full implementation of CBAM.

---

[33]Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism.
[34]Directive 2003/87/EC, Article 10a(1a), as inserted by Directive (EU) 2023/959: "Subject to the application of [CBAM Regulation], no free allocation shall be given in respect of the production of products listed in Annex I" of the CBAM Regulation.
[35]Directive 2003/87/EC, Article 10a(1a): CBAM factor schedule (97.5% in 2026, 95% in 2027, 90% in 2028, 77.5% in 2029, 51.5% in 2030, 39% in 2031, 26.5% in 2032, 14% in 2033, 0% from 2034).

3.2 HOW THE REFORMS OF EU ETS WOULD INTERACT WITH CBAM

The proposal amends the CBAM factor schedule in Article 10a(1a). Under the proposed new schedule, the CBAM factor (i.e. the percentage of benchmark-based free allocation retained by CBAM-sector installations) would be: 97.5% in 2026, 95% in 2027, 91.5% in 2028, 81% in 2029, 59% in 2030, 48% in 2031, 37.5% in 2032, 27% in 2033, and 15% from 2034 to 2037, falling to 0% from 2038. Compared to the current schedule (which reaches zero in 2034), this effectively reintroduces up to 15 percentage points of free allocation and extends the phase-out to 2038. The Commission's stated rationale is to address residual carbon leakage risk for CBAM sectors during the transition period.

Under the proposal, carbon removals are integrated at system level through a Commission purchasing programme rather than as operator-level compliance units. Removal-backed allowances enter the market through auctions, and CBAM certificate prices will continue to reflect auction clearing prices. The risk of inconsistency between domestic carbon costs and border adjustment is therefore limited, as the allowance price remains the common reference for both ETS operators and CBAM declarants. That being said, this risks introducing discrepancies between the treatment of EU operators, who can indirectly benefit from carbon removals, and non-EU operators covered by the scope of CBAM, whose possibilities to deduct carbon costs are limited and currently do not include carbon removals.

Non-CBAM sectors exposed to carbon leakage would continue to receive up to 100% of benchmark-based free allocation, extended until 2040, subject to the new investment conditionality. The proposal does not expand CBAM to additional sectors; any future expansion would depend on separate amendment of the CBAM Regulation.

The proposal also pre-defines the trajectory for goods added to CBAM in future: such goods would retain 97.9% and 95.8% of free allocation in the first two years of the next five-year period following their inclusion, then follow the general phase-out path.

The proposal maintains the Article 10a(1a) review clause addressing carbon leakage for exported CBAM products. For export-oriented production, the continued conditional free allocation through 2038 provides partial protection. The broader financing instruments introduced by the proposal, including the IDB, the Investment Booster, and enhanced use of ETS revenues, are designed to support the decarbonisation of EU industry and thereby reduce the cost differential with competitors in third-country markets over time.

Industry participants should monitor both the ETS revision and any consequential amendments to the CBAM Regulation closely, as changes to one mechanism necessarily require recalibration of the other.

4. Conclusion

The Commission's proposal represents one of the most significant revisions of the EU ETS. Driven by the legally binding 2040 climate target and multiple review mandates in the ETS Directive, combined with the difficulties faced by industry today, the Commission has opted to recalibrate the system for the post-2030 decade with tweaks both strengthening the EU ETS and diluting its effects somewhat: a slower cap trajectory aligned with 90% (or, with international credits, 85%) domestic ambition by 2040; integration of permanent carbon removals; a reformed MSR for a shrinking market; extended scopes on covered sectors; and extended but conditional free allocation designed to channel investment into industrial decarbonisation in Europe.

For industry, the commercial implications are substantial:

- **A softer but longer price trajectory.** The lower LRF and continued allowance issuance into the 2040s ease near-term supply pressure but extend carbon pricing well beyond 2040. Companies should update price assumptions underpinning investment cases, hedging strategies and long-term supply contracts.

- **Free allocation is no longer free.** From 2031, allocation depends on verified 'Invest in EU Decarbonisation Plans' and investing 100% of allocation value in EU decarbonisation, with 20% withheld until delivery is confirmed. Compliance planning must now integrate capital allocation and investment planning.
- **Relocation carries a price tag.** Companies receiving conditional free allocation that move covered production outside the Union must reimburse allowances received, a new factor in M&A and restructuring decisions.
- **Significant new funding**. The EUR 100 billion IDB, opening with the first in, first served Investment Booster from 2028, rewards project readiness. Early preparation of bankable projects, completion bonds and applications will be decisive.
- **CBAM sectors get more time, not a reprieve**. The slower phase-out to 2038 extends transitional free allocation but prolongs the dual CBAM/ETS compliance period. Importers and EU producers alike should re-run cost projections under the revised schedule.
- **New sectors enter carbon pricing.** Smaller vessels, extra-EEA departing flights and municipal waste incineration face surrender obligations from 2029–2031. Newly covered operators need MRV systems, registry accounts and compliance budgets in place well before the first surrender deadlines.
- **Removals and CCU become commercially relevant**. The purchasing programme, own-use BioCCS compensation and downstream CCU accounting create early-mover opportunities for hard-to-abate sectors and removal developers.
- **The final rules are not settled.** Trilogue negotiations will run into 2027 and key parameters, such as conditionality design, CBAM factors, scope extensions, may still change.

The proposal follows the ordinary legislative procedure. The European Parliament and the Council are expected to adopt their negotiating positions and engage in informal 'trilogue' discussions with the Commission to agree on a final text before it is formally adopted via the legislative procedure. The Parliament, Council and Commission signed the 'One Europe, One Market' roadmap in April 2026 setting Q1 2027 as the target for political agreement on the ETS review.

If adopted, Member States must transpose the Directive by 31 December 2028 and apply the measures from 1 January 2029, with a number of provisions (including free-allocation investment conditionality and certain scope extensions) applying from 1 January 2031.

Contacts

Gauthier van Thuyne
Partner

Tel +32 2 780 25 75
Mob +32 497 03 70 12
gauthier.vanthuyne@aoshearman.com

Alexander Pirard
Senior Associate

Tel +32 2 780 25 25
Mob +32 470 97 22 33
alexander.pirard@aoshearman.com