

Preparing the 2026 EU ETS/MSR Review

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EU Climate Policy under pressure

In the midst of a rapidly, and abruptly, changing context both at home and abroad, the EU has the formidable task of keeping its transformation towards a low-carbon future on track.

After the Russian invasion of Ukraine and China's rise as a dominant industrial competitor, the US transformed into an unpredictable rival instead of the decades long ally in support of multilateralism and security stability. Europe finds itself increasingly left on its own, and must find a way of squaring the objectives of industrial competitiveness, decarbonisation and strategic sovereignty.

The domestic political landscape of the EU and its Member States is increasingly fractured and confronted with the increased popularity of extremist political parties. Even if many of them do not question the existence of climate change - as records are increasingly being broken - they nevertheless challenge the usefulness and the practical implementation of many measures, or point the finger at others to take action.

These elements represent a major change to the political climate in which the first von der Leyen Commission developed the Green Deal. In the current legislative period 2024-29 its implementation should be strengthened by reducing the EU's dependence on imports of energy and raw materials, as well as through securing essential industrial supply chains within its borders. This Policy Brief aims to make recommendations for the upcoming review of the EU ETS and the Market Stability Reserve (MSR) which is planned to be launched in the second half of 2026.

The EU keeps delivering

By 2024 the EU cut its greenhouse gas emissions to 37% below 1990 levels, and they continue to decline. CO₂ emissions per head are coming close to the world average, which marks a difference compared to the US. These emissions reductions were achieved without significant macro-economic cost or losses in overall welfare. The target of climate neutrality by 2050 remains firmly on the table. The discussion on the intermediate target for 2040 has been politically intensive but delivered a solid compromise through bringing back a stronger international perspective and a range of flexibilities.

The predominant part of the EU's emissions reductions have been realised in the sectors covered by the EU ETS, and in particular the power sector. Since 2005, emissions in electricity and heat generation, and industrial production are down by 50%. The EU ETS price was

affected by the economic recession following the banking crisis of 2008 and later on by a massive influx of international carbon credits. With a delay the creation of the MSR successfully addressed the oversupply on the EU ETS market. The EU ETS carbon price is today hovering around €85 per ton of CO₂, close to a peak of €100 that was reached in Feb 2023. The governance has steadily improved and the EU ETS has become a trusted market managed by the European Commission in partnership with the Member States.

During the 20 years of the EU ETS existence, most of the emission reductions were delivered in the power sector through switching from hard coal and lignite to natural gas. Over the same period of time, the power sector was liberalised and subject to market forces. Massive investments were flowing in available alternative technology with low investment risk, which was found in natural gas piped from Russia. Following the Russian invasion of Ukraine and the related sanctions, the fuel switching was extended to renewable energy which in the meantime became a mature technology, with above all a significant security premium.

Challenges to the future of the EU ETS

While the past 20 years allowed the EU ETS to reap the low-hanging fruit, the next 20 years will be significantly different. Getting out of coal is well on its way, getting out of oil and gas will be more challenging. This transformation of the power sector should continue but requires huge investments. The further expansion of renewables is increasingly hindered by long permitting procedures and grid congestion. The system costs of a renewables-based power system characterised by intermittency are more comprehensive than anticipated. It is encouraging to observe that important investments in storage capacity, grids, and demand response are under way.

However, risks are looming on the horizon. The promise of cheap electricity prices following renewable investment is not yet being fulfilled. Moreover, the IEA is predicting that LNG prices will remain low in the coming years, while oil prices are not expected to increase. Despite the EU's willingness to increase overall electricity use, this is not happening fast enough, unlike China that leads this trend. High electricity prices are a major factor hindering the rapid uptake of electric vehicles and heat pumps. After the dream of cheap green hydrogen evaporated, industry is finally investing more in electrification.

At the international level, much of the European continent is subject to carbon pricing as the EU ETS includes EEA countries, is linked to Switzerland, and hopefully soon to the UK. Other compliance carbon markets already exist in some Canadian provinces, California, South Korea, and most importantly China, although they significantly differ in cap design, scope, allocation methods and other features. The EU introduced a Carbon Border Adjustment Mechanism (CBAM) in view of dealing with carbon leakage with a modality of reduced payment obligations if an explicit domestic carbon price has been paid by the exporter. This motivated countries such as Türkiye, Brazil, Vietnam, Indonesia, and even Japan to start introducing carbon compliance markets. The price gap in between the EU ETS and other emerging carbon markets is expected to remain significant and should not grow further in view of not discouraging other economies to follow the EU's carbon pricing path.

Europe's challenge to a low carbon transition seem to be threefold: the gas to electricity switch seems to be harder than expected; gas-based electricity to renewables will take more time; and electricity prices remain high hindering more electrification. Combined with the fact that other compliance markets continue to have lower carbon prices, calls are being made for not accelerating the pace of the EU's low-carbon transition.

The 'moderate success' of EU ETS

The EU ETS is a good example of pragmatism: a long-term and reliable disincentive is created to the use of fossil fuels. Graduality prevails, and shocks are avoided. The carbon price offers a clear long-term perspective. The system leads to cost-effectiveness as companies can decide which low-carbon technologies to introduce and at what moment in time. The availability of alternative technologies facilitated the transition and prevented a relocation of industrial production. Even if some modalities of the EU ETS are under discussion, business leaders generally prefer the light regulatory system of carbon pricing to detailed technical regulations.

The pragmatic, moderate, and gradual approach may also appeal to many voters in the so-called political center. Studies indicate that approximately a third of European voters support pragmatic and non-ideological climate policies. Carbon pricing can help winning over this so-called 'conditional middle'. Together with those already convinced of the need for climate policy a significant majority can be found, provided a pragmatic approach is maintained.

The risk of 'ambitious failure' of EU ETS

Such pragmatism is in contrast to the price forecasts of an unchanged EU ETS. Given the declining cap, some analysts expect the EU's carbon price to go up by as much as €50-100 per ton before 2030. This might increase further towards a price range of €250 and €400 per ton by 2040. While econometric models may show this as necessary, such forecasts seem politically challenging.

Apart from high price levels, those forecasts also hide some worrying assumptions. The predominant expectation is that much higher carbon prices will automatically drive significant emission reductions without aggressive plant closures. Experience shows that this is only the case when alternative technologies are available at competitive prices and with low risk. Industrial policy intervention can help the emergence of such low-carbon technologies, preferably home-grown. It should be recalled that economists repeatedly argued against the 'double regulation' policies on renewables when the EU ETS started, while this turned out to be a blessing in disguise. The EU ETS should therefore be part of a well designed industrial policy preventing the need for prohibitive carbon price levels. In the same vein, there is also a belief that less free allocation will automatically accelerate the industrial low-carbon transformation, while its strategic use as part of an industrial policy approach may be more helpful.

There is also the assumption that the EU ETS price curve will follow a rather smooth continuous upward trend. A shrinking market liquidity in line with the declining cap in combination with the EU's vulnerability to fossil fuels, increase the risk of price spikes and makes such smooth development rather unlikely.

The carbon price forecasts by modelers are based on the assumption that the current modalities of the EU ETS continue in the future. However, in order to keep the EU ETS fit for purpose and prevent it from a perception of failure against unrealistic expectations, important modifications should be considered.

Recommendations for the EU ETS/MSR Review

In light of the above discussion, this section puts forward three basic recommendations for the upcoming EU ETS and MSR review.

1. Manage allowance supply to moderate EU ETS prices

Very high carbon prices in the coming years are neither necessary nor desirable. This pleads in favour of a policy for preventing excessively high carbon prices. Some useful experience - both under the EU ETS and the ETS2 - is emerging through the indirect management of the supply of allowances. This management has been rules-based. In the future a careful calibration will be required between the LRF (linear reduction factor), the TNAC (total number of allowances in circulation), and the intake and release triggers of the MSR. Well-considered management of market liquidity would guarantee price formation to remain within an acceptable corridor.

The ETS review should go in tandem with the revision of the MSR. The MSR functioned well to neutralize the oversupply of allowances, but this task has now been achieved. It should therefore be considered to end the invalidation of allowances as soon as possible, preferably already as of 2027, thereby improving market liquidity before 2030. In the future the MSR should become an important tool to moderate upward price pressure. To this end, the parameters governing the MSR, in particular the release thresholds and modalities need a fundamental re-assessment. Serious consideration should be given to whether the rules-based governance needs to be complemented by a well-designed emergency procedure for the release of allowances in light of possible carbon price spikes.

The EU opened its 2040 target for the use of international carbon credits through Article 6 of the Paris Agreement. Domestically the EU is developing a certification system for trust-worthy domestic carbon removals. The EU could consider a centralised purchasing body for carbon credits of high quality that could act as a buffer before these are used for compliance in some selected climate policies. The MSR could act as such a buffer and could become the basis for possible liquidity creation in the EU ETS.

2. Re-purpose free allocation and develop coherence with the Clean Industrial Deal

The EU ETS needs to be developed in tandem with the Clean Industrial Deal. Additional resources should be directed to the creation and deployment of low-carbon technologies, along with policies aiming to expand market demand for low-carbon industrial products. Useful experience has been gained through the Innovation Fund for financing first-of-a-kind innovative low-carbon technologies. In addition, more resources need to support the scaling of proven technologies through the Industrial Decarbonisation Bank, also to accelerate the uptake of electricity. All EU ETS revenues should be deployed to support the low-carbon transition, including those flowing to the Member States. It could also be considered to bring fewer allowances to the auction platform, and reward companies directly with free allowances to the extent they invest in decarbonisation projects.

The EU ETS revenues should be spent in tandem with competition policy (Clean Industrial Deal State Aid Framework, CISAF) and in line with regional policy and major infrastructure investments. Indirect cost compensation via state aid should continue to be allowed, subject to conditions. Monitoring on how Member States use ETS revenues should be enhanced. As the EU ETS revenues become increasingly scarce, they should be prioritised to industrial innovation instead of expensive carbon removal activities.

Given the urgency of the industrial crisis, it could also be considered not to wait for the review of the EU ETS Directive, and to increase already now the access to free allowances provided these are spent on decarbonisation investments. The free allocation buffer of 3% (Art 10a5a), representing some 370 million allowances, could be used to kickstart the functioning of the Industrial Decarbonisation Bank. Some experimentation could be done taking some lessons from the US IRA, including the ex ante disbursement of free allowances on the basis of a limited number of well specified parameters, and using the “first come, first served” principle.

3. Widen the scope of carbon pricing

The CBAM regulation is a major innovation that will need to be managed in view of the recent developments on the international scene. It will be useful to avoid too wide a gap between carbon prices in the EU and other major economies, as otherwise unhelpful side-effects such as resource-shuffling or trade diversion may start to dominate the political debate. A CBAM diplomacy could unfold as the fore-runner of so-called carbon clubs in which mutual recognition of other ETSs could be considered.

Such issues could be taken up as part of the unfolding Clean Trade and Investment Partnerships (CTIPs) or in the context of implementing Article 6 of the Paris Agreement. A combined EU ETS/CBAM diplomacy could open up a pragmatic avenue to have more countries setting up emissions markets, getting away from coal and encouraging a switch towards natural gas, along with renewables. In addition the EU should invest in international cooperation on carbon credits in particular with countries not yet having a solid carbon pricing governance system. The EU should step up its efforts to spreading carbon pricing activities across the world and make it part of its diplomatic agenda.

The EU should also expand the scope of its internal carbon pricing towards an economy-wide coverage. Two decades of experience has shown that stable and long-term incentives to engage in decarbonisation pays off. For that reason the EU ETS2 is crucial and should go ahead as planned. Its revenues should be directed towards social support of low-carbon investments. In a not too distant future a merger with the EU ETS should be considered. A wider coverage will also enhance cost-effectiveness and support liquidity. Expansion should also include a bigger share of emissions related to international aviation.

Conclusion

The EU ETS should remain a pragmatic system incentivising consumers and investors across the economy, generating substantive emissions reductions in a cost-effective and gradual manner. The carbon price should be significant but moderate. Revenues should be used to support investments in low-carbon technology. It should align with current industrial policy interventions, similar to how it was done with renewables in the past. The upcoming review of the EU ETS should also proactively encourage other economies to adopt carbon pricing policies in view of spreading carbon pricing as wide as possible.