



Technical brief

EU ETS review: impacts on the market balance

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On 17 July, the European Commission published its review of the EU Emissions Trading System.

In this brief, we analyse how the proposed changes will impact the supply and demand balance of the emission allowance market. The measures with significant impact are (1) raising the cap, (2) issuing up to 260 million allowances to purchase carbon removals, and (3) changing the rules governing the Market Stability Reserve (MSR).

This brief is based on a small number of selected combinations of design options, whereas the full scope of combinations can be explored on our updated [EU ETS Simulator](#). Supply and demand numbers are given based on the emissions scenarios described by the impact assessment published by the European Commission in 2024 as part of the EU Climate Law:

- Emission scenario S1: 75% reduction in EU-wide emissions by 2040¹ (ETS sectors: -81%²)
- Emission scenario S2: 85% reduction in EU-wide emissions by 2040 (ETS sectors: -89%)
- Emission scenario S3: 95% reduction in EU-wide emissions by 2040 (ETS sectors: -93%)

The Impact Assessment provides emission breakdowns between power, industry, aviation, and shipping sectors. We translated these into forecasts for the sectors covered by the EU ETS, using short-term production forecasts from major business associations and drawing linear trajectories from short-term values to 2040 in the relevant sectors.

Having updated Sandbag's [ETS Simulator](#) with the latest (preliminary) emissions data, we found that the EU ETS ended 2025 with a total surplus of 2,190 million EUAs, which was brought down to **1,902m surplus allowances**, after 270m allowances from the MSR were invalidated on 1 January 2026. This is **1.7 times the level of emissions** covered by the scheme in 2025, estimated at 1,139m tCO₂.

The surplus breaks down as follows:

- 874m allowances in circulation;³
- 486m in the New Entrants Reserve;
- 117m unallocated allowances carried over from previous years;
- 25m in the Greece fund; and
- 400m in the MSR.

We calculated **excess EUAs** as the sum of allowances in circulation and the **New Entrants Reserve (NER)**, as it is likely that unallocated NER amounts will eventually reach the market, for example through the Investment Booster proposed by the European Commission. We therefore assumed that all amounts

¹ Compared to 1990 level

² Compared to 2005 level

³ This is less than the TNAC published yearly, which included net aviation demand before 2024.

locked in the NER will gradually be “in circulation”⁴. The total surplus amount includes excess EUAs as well as allowances locked up in other reserves, i.e. only the MSR in 2040.

Year	Total surplus (m EUA)	Emissions (m tCO ₂ e)	Surplus / Emissions
2026	1,902	1,139	1.7 x
2040	402	177 (S3 – 95%)	2.3 x
2040	-363	273 (S2 – 85%)	-1.3 x

Sandbag’s ETS Simulator was updated to include the main design features proposed by the Commission, except for extensions (e.g. to international flights and waste incinerators), the net effect of which should be small as they add both demand and supply to the market.

Cap as proposed by the Commission

The cap proposed by the Commission follows a trajectory with a lower linear reduction factor (LRF), from 4.4% (in the current directive) to 3.7% in 2031-2035 and to 1.7% in 2036-2040.

The Commission justified this new cap by the need to take into account the EU’s target of 85% domestic emissions reduction, after its 90% target was amended in November 2025 to include 5% from international credits. We have therefore tested this proposed cap against the emissions scenario S2, in which EU-wide emissions are reduced by 85% (compared to 1990 levels) by 2040, and EU ETS emissions are reduced by 89% (compared to 2005 levels).

We found that the Commission’s proposed cap would change the market’s balance from a deficit of 363m allowances to a surplus of **736m** allowances (including 400 million in the MSR), which is **2.7 times the emissions expected that year** (273m tCO₂ in scenario S2).

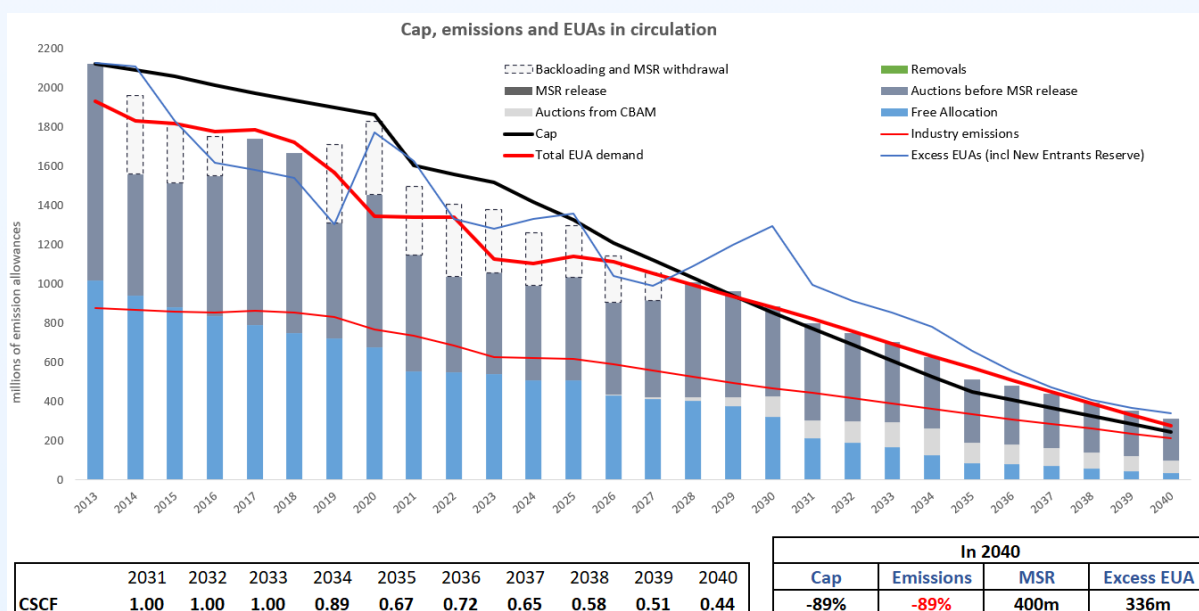


Figure 1: Cap as proposed by Commission in scenario S2

⁴ This is a slightly different approach from the one used in our recent brief [Let's not Invalidate Climate Policy](#), which only assumed 400 million EUAs being released from the NER, causing more allowances to be released from the NER.

The table below summarises the effect of the modified cap. In scenario S2, it increases the surplus by 1,099 million EUAs compared to the current cap.

Year	Total surplus by 2040 (m EUA)	Difference (brought by this feature only)	Emissions (m tCO ₂ e)	Surplus / Emissions
2040	736	+1,099	273 (S2 – 85%)	2.7 x

Allowances for the purchase of domestic removals

According to the newly proposed Article 9c, the total number of allowances would be increased by 260 million, made available from 2031 to 2040 to generate revenues for the purchase of “an *equivalent amount* [of 250 million] domestic permanent carbon removal units generated by BioCCS and DACCS activities” (emphasis added). It should be noted that the Commission is therefore ready to pay no more than 1.04 EUA per removal unit.

Under scenario S2, assuming the allowances are sold in equal amount each year between 2031 and 2040, this policy design would lead to a **surplus of 996m allowances**, equivalent to **3.6 times the emissions expected in 2040**. This would cause a price drop so steep that the emissions reduction goal set for S2 could only be achieved through other policies than the ETS alone.

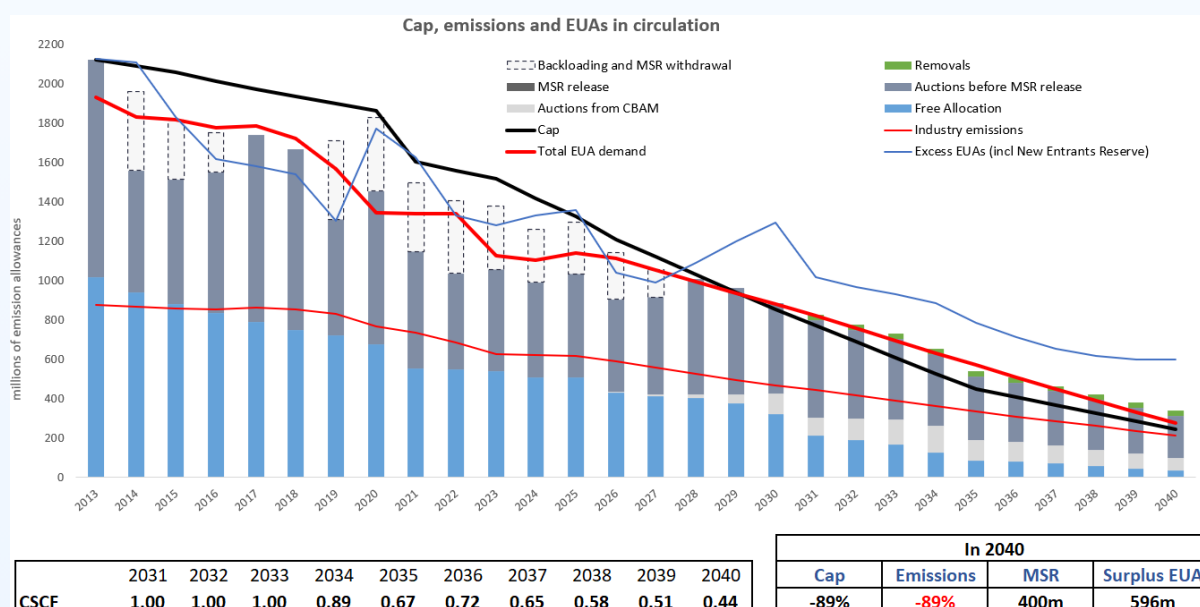


Figure 2: With 260m allowances sold for the purchase of BioCCS and DACCS activities, in scenario S2

The table below summarises the effect of the 260 million EUA sales for removals combined with the higher cap, with the difference it creates.

Year	Total surplus by 2040 (m EUA)	Difference (brought by this feature only)	Emissions (m tCO ₂ e)	Surplus / Emissions
2040	996	+260	273 (S2 – 85%)	3.6 x

With modified MSR withdrawal / release rules

The Commission's proposal includes a new calculation of the Total Number of Allowances in Circulation, which effectively increases the MSR thresholds, triggering withdrawal and release from the MSR at higher levels of excess EUAs. On the other hand, the nominal values of these thresholds are reduced by 4% per year, which has the reverse effect, especially in later years.

When combined with the above design features, this measure results in a surplus of 1,100 million allowances (including 465 million in the MSR)⁵, equal to 4.0 times the emissions in 2040. This single measure creates a net addition of +104 million allowances. It should be noted that, in this configuration, 239 million more allowances are invalidated compared to the configuration of the previous section.

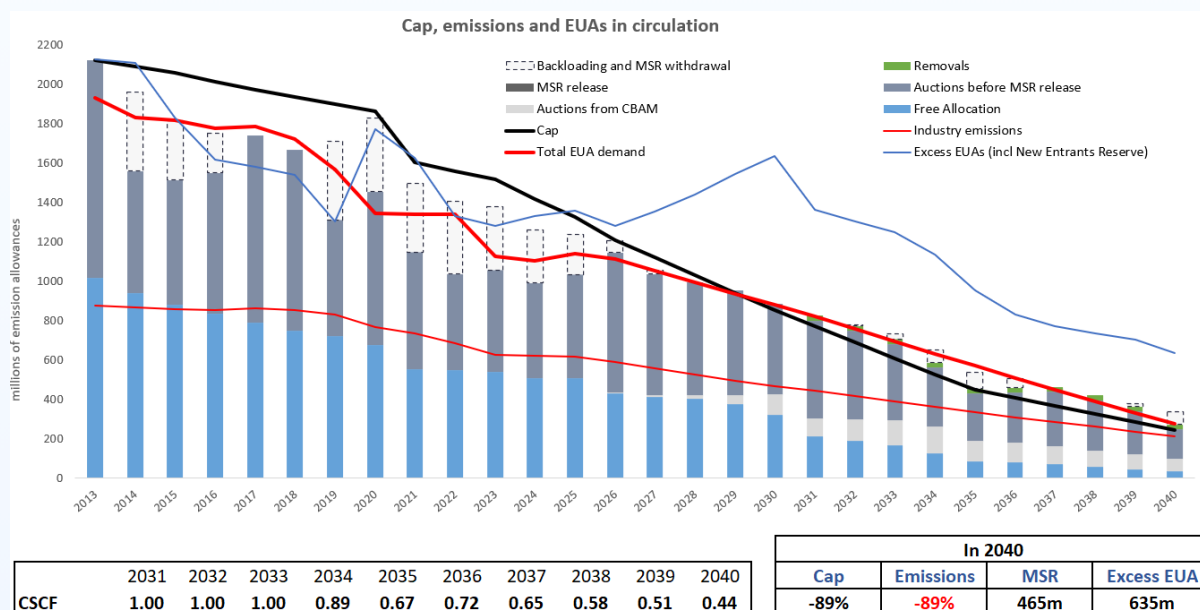


Figure 3: With proposed MSR rules for withdrawal and release, in scenario S2

Year	Total surplus by 2040 (m EUA)	Difference (brought by this feature only)	Emissions (m tCO ₂ e)	Surplus / Emissions
2040	1,100	+104	273 (S2 – 85%)	4.0 x

Without MSR invalidation

A separate legislative proposal made by the Commission in April 2026 consisted of no longer invalidating allowances from the MSR in excess of 400m, as is currently done. If this policy feature is adopted, alongside all the above proposals, scenario S2 would result in a surplus of 1,540 million allowances in 2040, equal to **5.6 times the emissions that year**.

⁵ The amount at the end of each year can exceed 400 million, as the invalidation only occurs on 1 January of the following year.

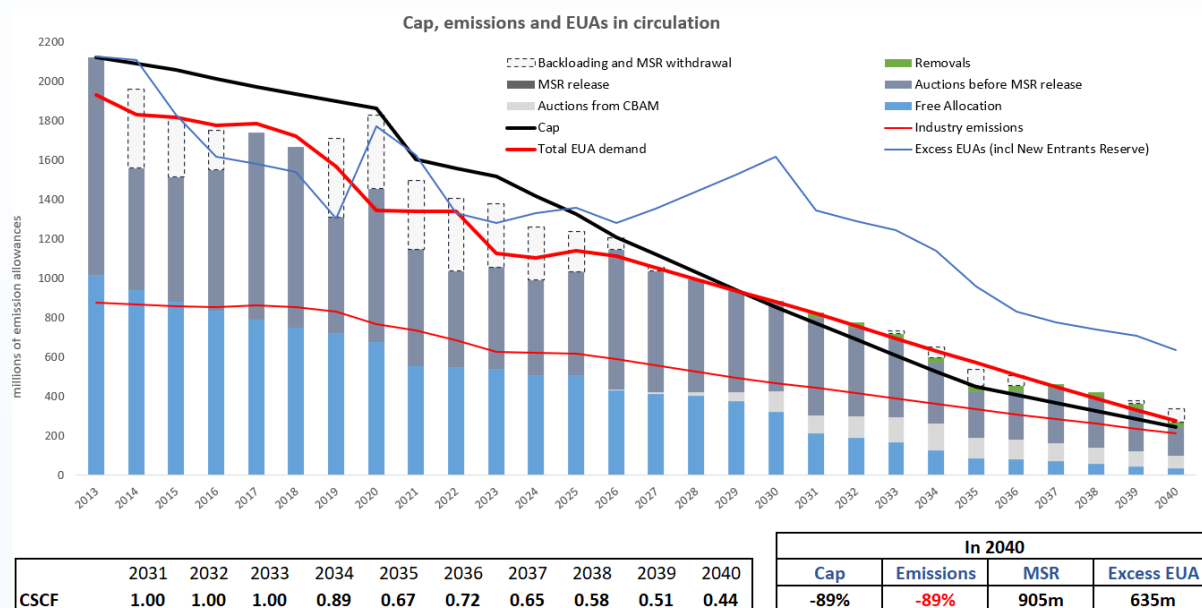


Figure 3: Combined design options proposed by the Commission, in scenario S2 (-85% EU wide emissions)

We also tested this configuration against the emissions scenario S1, where EU-wide emissions are only reduced by 75%. It would result in a surplus of 757 million allowances in 2040 (including 559m in the MSR), compared to emissions of 443 million tCO₂. This would bring the surplus back to **1.7 times the emissions that year**, which is exactly the same ratio as today. It is therefore likely that market forces, through the carbon price, would drive emissions to the S1 scenario (-75% EU wide) rather than S2 (-85%).

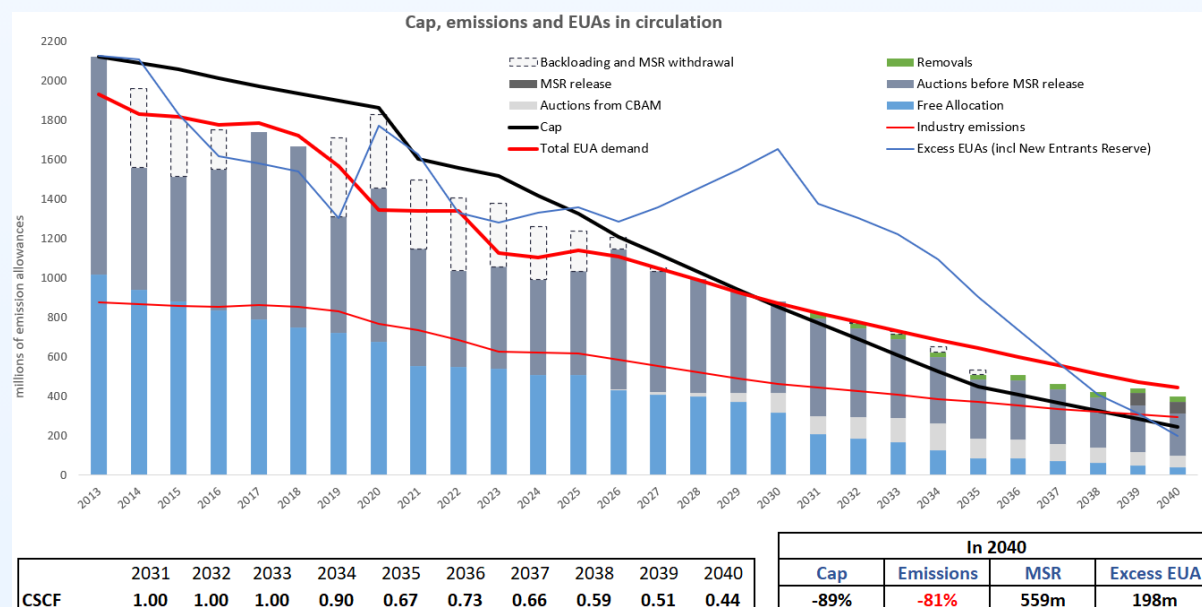


Figure 4: Combined design options proposed by the Commission, in scenario S1 (-75% EU wide emissions)

Year	Total surplus by 2040 (m EUA)	Difference (brought by this feature only)	Emissions (m tCO ₂ e)	Surplus / Emissions
2040	1,540	+440	273 (S2 – 85%)	5.6 x
2040	757	+291	443 (S1 – 75%)	1.7 x

Summary table

The combined design features proposed by the Commission amount to a **net increase of 1,903m allowances** over the period to 2040. They increase the surplus/emissions ratio from 1.7x today to 5.6x in 2040 if emissions follow the desired -85% reduction target. The ratio would be brought back to 1.7x in 2040 if emissions only follow a less ambitious -75% emissions reduction pathway.

Feature	Total surplus by 2040 (m EUA)	Difference (brought by this feature only)	Emissions (m tCO ₂ e)	Surplus / Emissions
Cap	736	+1,099	273 (S2 – 85%)	2.7 x
Removals	996	+260	273 (S2 – 85%)	3.6 x
MSR rules	1,100	+104	273 (S2 – 85%)	4.0 x
No invalidation	1,540	+440	273 (S2 – 85%)	5.6 x
Total	1,540	+1,903	443 (S1 – 75%)	1.7 x

The background features a white central area framed by dark blue geometric shapes: a triangle in the top-left, a triangle in the bottom-right, and a horizontal bar at the top. On the left and right sides, there are sets of concentric, light blue circular lines that appear to emanate from the edges.

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