sandbag
smarter climate policy

The EU ETS at a crossroads

Response to public consultation – July 2025

The European Commission is running a public consultation and call for evidence on the design of the EU ETS's beyond 2030, including the treatment of aviation, shipping, indirect cost compensation, the CBAM, extension to municipal waste, carbon removals and carbon capture and utilisation.

This brief is Sandbag's response to the "call for evidence" part of the consultation, submitted on 8 July 2025.

Free allocation phaseout as a means of simplification

We have repeatedly criticised free allocation as an obstacle to decarbonisation, to innovation and to the good functioning of the carbon market[1]. We believe it is also an absurd source of complexity.

Free allocation (FA) is also a source of unnecessary bureaucracy, as demonstrated by the complexity of its two supporting legislative texts: the Free Allocation Regulation (FAR) and Activity Level Change Regulation (ALCR). As FA benchmarks are based on the 10% least emitting plants for each of the 54 benchmarks, the **FAR** requires collecting confidential production data from all ETS-covered plants over long periods of time. In a document called National Implementation Measures (NIM), each country submits data on the production activity of their plants, broken down to the level of each process (called **sub-installations**), including data such as transfers of heat and gases, electricity production and emissions over the previous five years. The NIMs then undergo a consistency check and a completeness check by the European Commission, then additional assessments for certain installations. The Commission rejects or accepts the NIMs. This clears the way to **preliminary free allocation**.

This is when the **ALCR** comes into play. Each year, free allocation is adjusted to the activity level of each sub-installation in the previous two years. This requires the transmission of an activity level report by each installation operator to the national authorities. National authorities calculate and submit **adjusted FA** amounts for each installation, which the Commission validates. FA adjustments depend on the **New Entrants Reserve (NER)**.

Another direct consequence of free allocation is the need to apply a **cross-sectoral correction factor (CSCF)**, which is a multiplier with a value between 0 and 1. Since the number of free allowances is based on a plant's output, there is a risk that their total number would exceed the ETS cap. The CSCF is calculated so as to prevent this from happening by uniformly reducing the number of free allowances allocated to each plant. **Final allocation** is published in **National Allocation Tables (NAT)**. This unpredictable factor creates **uncertainty** for plant operators over the number of allowances they will receive and the system's complexity creates **risks of litigation**. For example, the German

[1] See for example Sandbag (2021) Why Free Allocation in the EU ETS Must Stop Urgently, or Sandbag (2022) Reform, not a patch, will curb carbon price volatility

companies Borealis Polyfine GmbH and OMV Refining & Marketing GmbH claimed the European Commission did not correctly determine the maximum annual amount of allowances which had led to the CSCF being miscalculated. The Court ruled in favor of the operators and the Commission had to adjust its CSCF value for the upcoming years. This created **legal uncertainty** as the CSCF values in Annex II of the Commission's CSCF decision were no longer applicable and operators had little clarity on how their future FA would be affected.

To make free allocation less favourable to polluters, **conditionality requirements** have been introduced, obliging operators to run **energy audits** or adopt certified energy management systems, then submit a **Climate Neutrality Plan** outlining measures to reach climate neutrality by 2050 at installation level, intermediate targets and milestones to measure this progress every five years and include an estimate of the impact of each of the measures. The climate plans then must be duly **reported on, monitored and verified (MRV)**, then those MRV reports checked by the Commission.

The phasing out of free allocation would reduce all these administrative procedures and related costs, as well as address all the other issues raised.

Aviation: put a seat belt on EUA supply

The aviation sector has been exceeding its emissions cap most years since the creation of an aviation ETS. Instead of keeping their emissions in check, airlines benefit from a **cheap means of compliance** to the aviation ETS by buying allowances issued under the stationary ETS (EUAs), on top of aviation allowances (EUAAs). EUAs are notoriously oversupplied, with some of the excess removed every year by the Market Stability Reserve (MSR). As a result, air traffic and its related emissions are rising, instead of falling.

We propose to **restrict access to EUAs for aviation**, so that the allowances available to airlines will be limited to EUAAs and a **gradually declining number of EUAs**. This would help align aviation emissions with their cap, ensure CO2 emission externalities are better reflected in tickets prices and make lower-carbon transport alternatives more competitive. Higher EUAA prices would also raise more funds.

CORSIA has proven to be ineffective at tackling emissions from international aviation. International aviation should be included in the aviation ETS and be subject to the same restricted access to EUAs.

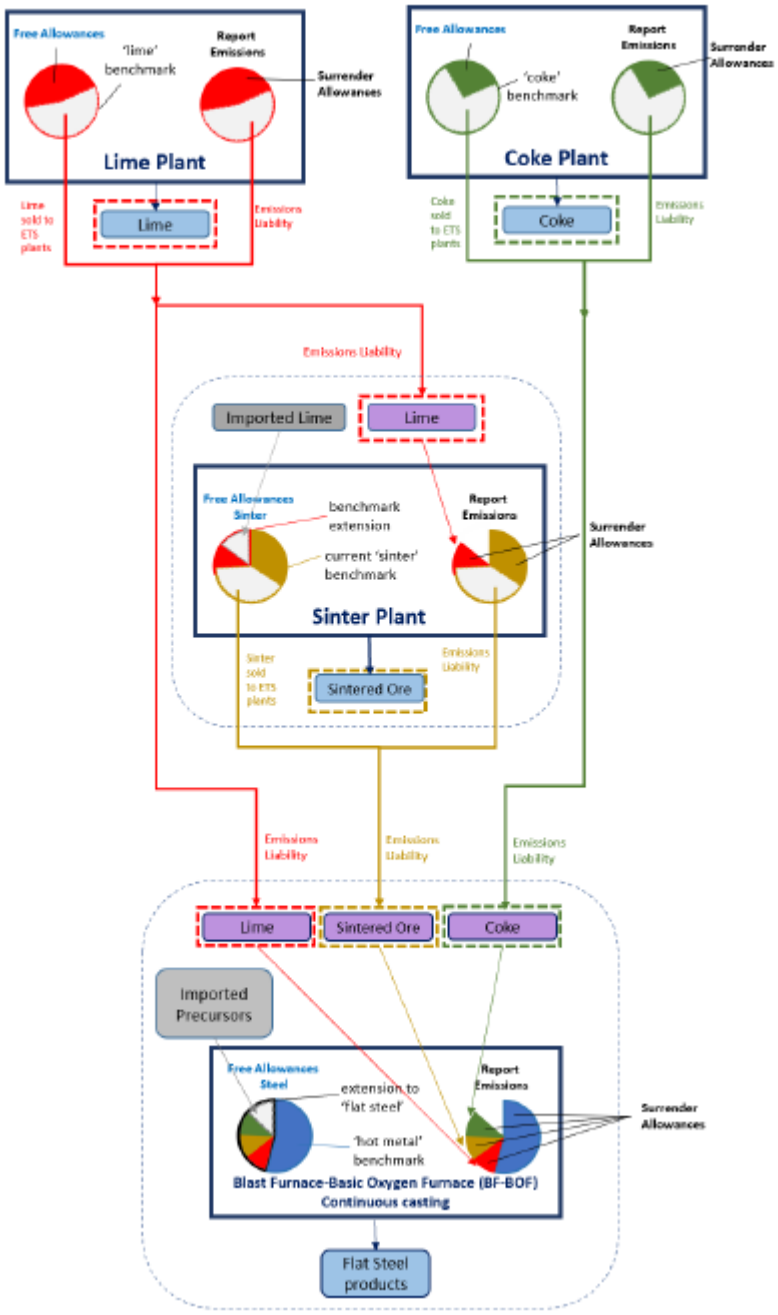
Sustainable Aviation Fuels (SAF) may be part of the solution to air transport emissions, but they shouldn't be subsidised. Subsidies to SAF tend to divert efforts away from other technologies such as zero-emission aircraft. In addition, SAF subsidies may divert hydrogen from other more efficient uses such as industrial decarbonisation, making decarbonisation in these sectors harder.

SAF has drawbacks. Those made from biomass tend to increase the strain on land use and imported deforestation, whereas e-fuels produced according to the RFNBO standard create **induced emissions** (see Sandbag (2025) Getting Electrification Right: The broader challenge of induced emissions).
As airlines face very little exposure to carbon leakage, they can finance SAF use through higher ticket prices. Revenues raised from the aviation ETS could be used in more efficient ways such as rail transport infrastructure. Higher ticket prices would also reduce demand and make rail transport more competitive.

Free allocation: switch from process to product

The Free Allocation Regulation should be made proportional to product output rather than process output. For example, it should be proportional to flat steel and long steel product output rather than to pig iron, coke, lime, agglomerated ore (as illustrated below), or even hydrogen. Please read the detailed proposal in Sandbag (2023a) From Process to Product: A Fix to the Allocation of Free Emission Permits to Industry, and also Sandbag (2023b) Flat Steel in the Free Allocation Regulation.

Free allocation for production of flat steel on BF-BOF route



Link indirect cost compensation (ICC) to carbon-free electricity only

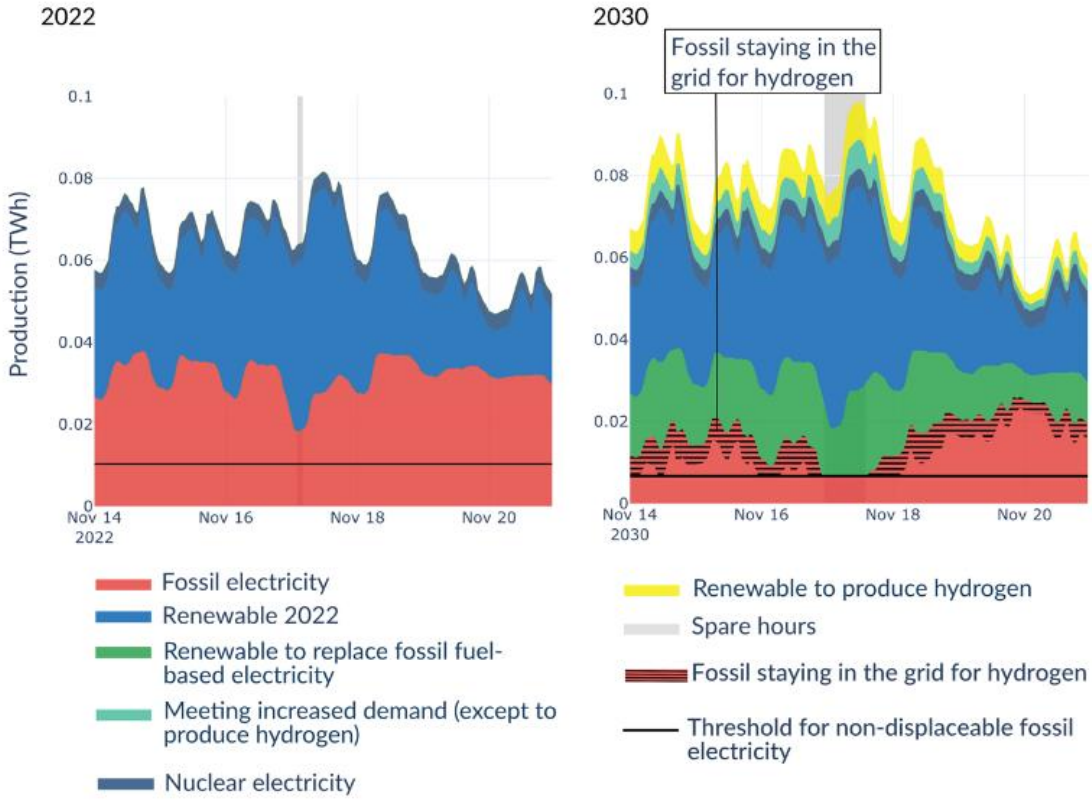
Currently, all electricity consumed by an industrial plant is eligible for compensation. This provides no incentive to use renewable electricity and does not reward the efforts made to adapt to an intermittent source of electricity.

We propose that ICC should only be given to the non-fossil share of the electricity consumed, only at times when fossil electricity sets the marginal price.

Such a system would incentivise the use of renewable electricity by EU industry plants. In addition, it would make ICC compatible with the CBAM, by decorrelating ICC from indirect emissions. An extension of the CBAM to indirect emissions would then become possible, as EU plants would no longer be receiving a subsidy covering their indirect emissions.

Reform the Innovation Fund

Expected fossil power generation induced by the production of RFNBO in Germany



Source: Sandbag (2025)

We responded separately to the public consultation on the Innovation Fund. Our response can be seen here, and our recommendations are summarised below:

- Stop counting electricity use as carbon-free, and start counting **induced emissions**: see Sandbag (2025) Getting Electrification Right: The broader challenge of induced emissions
- Reserve grants to cover technology risk, and not criteria such as novelty, cost or geography
- Reserve scale-up subsidies (like fixed premia) to deprived sectors (e.g. not receiving free allowances) rather than subsidising e-fuels.

Market stability reserve: reduce the reinjection rate

The upper and lower thresholds of the MSR should be adjusted downwards, to a level corresponding to the full removal of surplus allowances. The MSR gets activated by testing a "total number of allowances in circulation" (TNAC) against an upper and lower threshold of 833m and 400m EUA, respectively. But since the TNAC calculation method over-estimates the surplus EUA by about 180m, upper and lower thresholds should be adjusted down to that same amount (180m), gradually.

When the surplus falls below the lower threshold, the number of permits reinjected by the MSR is currently 100m per year, whatever the gap with that threshold. This currently corresponds to about 10% of yearly demand, but it will represent an increasing share.

We propose that **the number of reinjected EUAs be adjusted (reduced)** proportionately to yearly demand for EUAs.

Keep carbon removals out of the ETS

Our ETS+CDR Simulator, based on the 2040 target Impact Assessment modelling, shows that the ETS can function without CDR until 2040. Allowing CRCF removals for EU ETS compliance would risk mitigation deterrence, price suppression, and negative externalities. Integration would only incentivise the cheapest, biomass-reliant CDR methods (e.g. biochar, BECCS), creating risks of unsustainable biomass demand and market destabilisation and not building the balanced portfolio of CDR that will be needed to reach climate neutrality. Attempts to level the playing field (i.e. through CCfDs) would be very costly and distort price signals in the market. Instead, removals should be developed outside the ETS through dedicated support mechanisms without risking the functioning of the ETS during the critical next decade. Integration may be needed from 2040 to counterbalance the last remaining emissions, but only under strict conditions.

In the short-term, CDR could be developed via a **purchasing programme**, which invests in learning, leads to cost reductions and builds confidence in permanent CDR and the underlying MRV, to be appropriate. In the medium term, a number of possible policy instruments are on the table (Removal Trading System, Extended Emitter Responsibility, ESR-style Member State targets), which could support the scale-up of high-quality, permanent CDR. Each presents distinct trade-offs and implementation challenges but, we consider, offer greater control over the amount of CDR being incentivised, and with fewer risks to emission reductions, than ETS integration. The European Commission should undertake a thorough impact assessment of these different policy pathways to determine which instruments are best suited to effectively incentivise CDR development while maintaining coherence with the broader EU climate policy framework.

Do not shift CCU carbon accounting down value chains

Shifting carbon accounting downstream opens the door to widespread underreporting of emissions and risks turning the EU ETS into a subsidy for temporary carbon re-use. In practice, it is neither credible nor enforceable to implement robust MRV across all end uses of carbon—particularly for short-lived products like fuels, plastics, or chemicals. These forms of 'non-permanent' carbon capture and utilisation (CCU) offer no meaningful climate benefit, yet allowing them to reduce ETS compliance obligations would create a gaping loophole for industrial and power sector emissions.

Limit linking with other ETS

The EU should cautiously pursue further ETS linking opportunities, especially with smaller peripheral countries, provided that environmental integrity and robust governance frameworks are maintained. This can support regional decarbonisation, promote carbon pricing alignment, and strengthen climate diplomacy. It also helps avoid carbon leakage by bringing non-EU emitters under a comparable carbon price.

ENP Countries (Eastern partnership) could also be integrated into the scope of the ETS with the aviation sector being a first step. Candidate countries aspire to EU membership which increases the EUs leverage.

However, poor MRV systems or inadequate enforcement mechanisms in linked countries could jeopardise the environmental credibility of the EU ETS. A linked system is only as strong as its weakest component, and if allowances from countries with poor oversight flood the market, it could undermine the EU's climate ambition and carbon price signal.