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BRIEFING

EU ETS Phase V: The Commission's blueprint for carbon pricing beyond 2030

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The European Commission has published a proposal to revise the EU Emissions Trading System (EU ETS) for the period 2031–2040 (Phase V), launching what is likely to become one of the most politically significant climate reforms of the current legislative cycle. The proposal, part of the broader package implementing the EU's recently adopted 2040 climate target of a 90% net greenhouse gas emissions reduction compared to 1990 levels, reflects a notable shift in the Commission's approach: while preserving the EU ETS as the cornerstone of European climate policy, the proposal places substantially greater emphasis on industrial competitiveness, affordability and investment predictability than previous reforms.

Key issues

1. EU ETS extended to departing international flights from EEA airports to destinations within 5,000 km from Frankfurt Airport and to all incoming and departing flights by "business jets".
2. Industrial Decarbonisation Bank (IDB) to mobilise approximately €100 billion between 2030 and 2040 to support the deployment of low-carbon technologies across European industry.
3. Integration of permanent domestic carbon removals under strict quality and quantity safeguards.
4. Extended direct support to aviation sector for the uptake of EU-produced sustainable aviation fuels, clean technologies and hydrogen.
5. Extension of the EU ETS to smaller shipping vessels (400–5,000 GT). A new dedicated maritime reserve fund for sustainable maritime fuels and zero-propulsion technologies.
6. Municipal waste incineration to be brought within the EU ETS framework.

The proposal, published on 17 July 2026, arrives against a backdrop of sustained concern from European industry regarding energy costs, the pace of decarbonisation obligations, increasing global competition (particularly from jurisdictions with less stringent carbon constraints) and the need to support innovative low-carbon technologies.

For businesses operating in EU ETS-covered sectors, the proposal is important not because it changes the direction of travel, but because it may significantly alter the pace, cost profile and financing environment of the transition during the 2030s.

KEY PROPOSED CHANGES

A more gradual decline in the emissions cap

The most consequential aspect of the proposal is the revision of the emissions cap trajectory after 2030.

Under the current framework, the annual cap on emissions allowances declines through a linear reduction factor (LRF) of 4.3% applied annually from 2024 to 2027 and 4.4% from 2028 to 2030. The Commission now proposes reducing the LRF to 3.7% for the period 2031–2035 and 1.7% from 2036 onwards. According to the Commission, the existing trajectory would have driven the cap to zero around 2040 – quicker than required under the European Climate Law[1].

The practical implication of the proposal is that allowances would continue to enter the market further into the 2040s than under the existing trajectory. As a result, the market is likely to experience a less acute supply squeeze than many analysts had anticipated under previous assumptions.

For industrial companies, this does not remove the need to decarbonise. The EU ETS cap will continue to tighten substantially and emitters will continue to face rising compliance obligations over time. However, the revised trajectory could help smooth investment cycles and reduce the risk of sudden carbon-cost escalation. In particular, energy-intensive sectors with long asset lives – such as steel, cement, refining, chemicals and fertilisers – may welcome the additional flexibility provided.

Aviation and maritime sectors: Scope extension and deployment of sustainable fuels

Under the current EU ETS Directive, the Commission was required to assess the effectiveness of the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) by 1 July 2026 based on whether it covers at least 70% of international emissions and is therefore aligned to Paris Agreement targets; and to make proposals to extend CORSIA to international flights if required. The Commission's assessment of CORSIA was published alongside the EU ETS proposals in July and concludes that currently CORSIA is falling short of its target coverage.

The Commission, therefore, proposes extending the scope of the EU ETS to cover all flights departing from EEA airports and landing in third countries

[1] Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021.

no further than 5,000 km from Frankfurt Airport, the largest aerodrome closest to the geographical centre of the Union. This would apply for a period of four years from 2029 but may be rolled back depending on the outcome of the Commission's next review of CORSIA, which is required by 2032. The ETS would also be extended to all incoming and departing flights by "business jets". This term is yet to be precisely defined, but the extension aims to close a gap under which most business aviation, both commercial charter and private/non-commercial operation, is in practice exempted due to current thresholds.

To address concerns regarding overlapping compliance obligations, the proposal introduces a mechanism allowing aircraft operators to deduct costs incurred under CORSIA from their EU ETS obligations in certain circumstances. The objective is to avoid double carbon pricing while preserving the EU's ability to pursue a higher level of climate ambition through the EU ETS.

The proposal also extends the scope of the maritime EU ETS to smaller vessels. Currently, the maritime EU ETS applies to ships of 5,000 gross tonnage (GT) and above. The EU ETS would be extended to certain categories of vessel between 400 and 5,000 GT. The scope extension is accompanied by a corresponding increase in the overall EU ETS cap to reflect the additional emissions. It also introduces a Commission review clause to address the risk of double payment once a global measure is adopted by the International Maritime Organization (IMO).

The proposal also increases support to the sustainable aviation and maritime industries by increasing direct support for deployment of clean propulsion technologies and hydrogen sectors from EU ETS funds. This includes, in particular, a new 110 million allowance reserve to support shipping companies to cover the price differential between fossil fuels and eligible sustainable maritime fuels and deployment of zero-emission propulsion systems.

A new carbon cost for the waste sector

One of the most significant scope extensions proposed under the Phase V review is the gradual inclusion of municipal waste incineration within the EU ETS. The proposal introduces a phased surrender obligation: waste-to-energy operators would be required to surrender allowances for 25% of their verified emissions reported for 2031, rising to 50% for 2032, 75% for 2033 and 100% from 2034. While waste-to-energy facilities have historically remained outside the carbon pricing framework, the Commission now considers the sector to represent a material source of emissions that should contribute to the achievement of the EU's 2040 climate objectives. At the same time, the proposal provides support for the sector through continued support for district heating, funding for cleaner technologies and carbon capture, and priority use of EU ETS revenues to improve local waste management. Notably, individual Member States may opt out from the measures until 2035 if at least two out of three conditions are met (equivalent national carbon tax; on track for recycling targets; on track for the landfill target or a lower landfill target). Incineration of hazardous waste remains outside the EU ETS.

Historically, incineration was treated more favourably than landfill under EU waste policy. However, as landfill volumes have fallen and

decarbonisation targets have become more ambitious, policymakers are increasingly focusing on the emissions generated by the combustion of fossil-based waste streams, particularly plastics and other non-biogenic materials.

The reforms also change how carbon emissions are accounted for in relation to certain products where carbon is released, captured and/or used at different stages of a production chain (for example, for synthetic fuels, chemicals and other products that incorporate recycled carbon). They are also linked to the Commission's intention to prevent double counting and to create a more coherent accounting framework for carbon capture and utilisation pathways.

Reforming the Market Stability Reserve

The Commission proposes significant changes to the Market Stability Reserve (MSR), the mechanism used to manage structural imbalances between allowance supply and demand.

While the EU ETS is intended to provide a meaningful carbon price signal, policymakers and industry stakeholders have become increasingly concerned about excessive volatility and its potential impact on investment decisions, electricity prices and industrial competitiveness, particularly as the market is shrinking.

Under the proposal, the rate at which surplus allowances are absorbed by the MSR would be reduced from 24% to 12% from 2028 and the upper threshold at which that intake is triggered would be adjusted down to reflect the lower rate. The MSR already operates an upper buffer alongside the upper threshold: when the total number of allowances in circulation (TNAC) sits between the two, only the excess above the buffer is withdrawn, rather than the full amount above the threshold. The proposal introduces an equivalent lower buffer beneath the existing lower threshold, currently set at 400 million allowances. Where TNAC falls between the lower threshold and the new lower buffer, the MSR would release a variable amount equal to the shortfall against the threshold, rather than the current fixed release of 100 million allowances; the fixed release of 100 million would instead apply only when TNAC drops below the buffer itself. From 2029, all four reference points, the upper and lower thresholds and their respective buffers, would decline by 4% each year, so the MSR narrows in step with the shrinking cap while retaining the same buffered structure on both sides of the market.

The reforms would also remove the controversial invalidation mechanism, under which allowances in the reserve above a 400 million threshold are cancelled, so that these can be kept in the reserve as a buffer to support future market stability efforts.

Carbon removals and international credits

Carbon removals brought into the compliance market

One of the key structural changes proposed under the EU ETS review is the introduction of a limited framework for the integration of permanent carbon removals into the system. For the first time, permanent carbon removals would gain access to a compliance-driven source of demand

linked directly to the EU ETS. The proposal reflects the revised European Climate Law and the EU's 2040 climate target, both of which recognise that achieving climate neutrality will require not only deep emissions reductions but also the deployment of permanent carbon removals to compensate for residual emissions from hard-to-abate sectors.

One of the most notable features of the proposal is the introduction of a framework for integrating 250 million tonnes of permanent domestic carbon removals into the EU ETS between 2031 and 2040, with an additional contingency reserve of 10 million tonnes in allowances. Eligibility would be limited to removals certified under the Carbon Removal and Carbon Farming Certification Framework (CRCF), initially covering technologies such as Direct Air Carbon Capture and Storage (DACCS) and Bioenergy with Carbon Capture and Storage (BioCCS). To preserve environmental integrity, stored carbon would remain subject to the EU ETS monitoring, reporting and verification regime. The Commission proposes to act as a central purchaser of eligible removals, financing acquisitions through the auctioning of the additional allowances. In doing so, the proposal seeks to establish a predictable compliance-driven source of demand for high-quality removals and support the scale-up of technologies that are expected to play an important role in achieving climate neutrality.

International carbon credits

Reflecting the recent revision of the European Climate Law, the Commission has also proposed a mechanism to facilitate the future use of high-integrity international credits from 2036 onwards. While the Climate Law permits up to 5% of the EU's 2040 climate target to be achieved through high-quality international credits, the proposal does not reintroduce international offsets as instruments that can be directly surrendered by EU ETS participants.

Instead, the Commission proposes the establishment of a dedicated Union-level facility that could purchase eligible international credits and use them to create additional emissions space within the EU ETS. Under the proposal, this mechanism could increase the volume of allowances available within the system by up to 2% (capped at a total of 260 million tonnes over the 2036–2040 period), providing a limited degree of additional flexibility while remaining consistent with the overall objective of achieving a net 90% reduction in greenhouse gas emissions by 2040.

Nevertheless, if sufficient high-quality, high-integrity credits are not available (to be assessed via a Commission report due by January 2033), the LRF, as the operative mechanism, would automatically revert to a steeper trajectory, requiring the "90% emissions reduction by 2040" target to be met by domestic action alone and any unused set-aside allowances would be redirected to the Industrial Decarbonisation Bank (IDB).

Carbon leakage, CBAM and industrial competitiveness

The Commission's proposal also reflects a more pragmatic approach toward carbon leakage risks than was evident in some earlier iterations of EU climate policy.

Although the Carbon Border Adjustment Mechanism (CBAM) remains central to the EU's strategy, the Commission acknowledges that many sectors continue to face exposure to international competition and

carbon-cost differentials. The proposal therefore slows and extends the phase-out of the free allocation of carbon allowances under the CBAM to 2038 (from the original 2034 timeline), with the 15% of free allocation already phased out reintroduced from 2028.

Crucially, from 2031, all free allocation will be made conditional upon operators developing independently verified five-year 'Invest in EU Decarbonisation Plans'. These would require operators to invest 100% of the funds from their free allocation during that period in projects to decarbonise their activities, and achieve "significant emission reductions". Of the free allowance allocation, 80% would be released annually upon submission of the plan and the remaining 20% released only upon verified implementation of the decarbonisation investments and achievement of corresponding emission reductions by the end of the five-year period. A separate benchmarks proposal aims to increase free allocation to industry by €6 billion for the period 2026–2030.

This aspect of the reform is likely to become one of the most contested issues during negotiations between the Council and Parliament. Environmental organisations have already argued that extending free allocation weakens decarbonisation incentives and risks undermining the environmental effectiveness of the EU ETS. Industry, by contrast, is likely to argue that additional safeguards remain necessary in light of higher European energy costs and intensifying international competition.

Industrial Decarbonisation Bank: €100 billion to support industrial transition

Alongside the proposed EU ETS reforms, the Commission proposes the establishment of a new IDB expected to mobilise approximately €100 billion between 2030 and 2040 to support industrial decarbonisation. The initiative reflects the Commission's view that carbon pricing alone will not deliver the level of investment required to transform Europe's industrial base.

An initial Investment Booster would begin operating from 2028, financed through the auctioning of 400 million ETS allowances (corresponding to approximately €30 billion of support). Funding would be allocated on a "first-come, first-served" basis to accelerate investment decisions ahead of 2030.

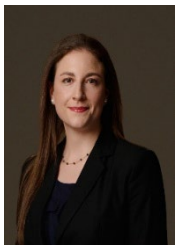
From 2031, the full IDB would support projects through competitive funding mechanisms, while the Innovation Fund would continue focusing on innovative technologies requiring support to reach commercial maturity. Hydrogen, CCS, carbon removals, industrial electrification and sustainable fuels are expected to be among the principal beneficiary sectors.

OUTLOOK

The Commission's proposal marks an evolution in EU climate policy. Having for years concentrated on maximising emissions reductions through increasingly stringent carbon constraints, the Commission appears to be shifting towards an integrated regime combining carbon pricing, carbon removals, industrial support and limited international flexibility as complementary tools for achieving the Union's 2040 climate target.

For businesses, the key message is that the EU ETS remains firmly at the centre of the European decarbonisation agenda. However, Phase V appears likely to be characterised by a more flexible and economically pragmatic approach than previous reform cycles – one that may create both compliance risks and commercial opportunities across the energy, industrial and carbon management sectors.

Regarding the next steps of the legislative process, intense debate is expected from September 2026 onwards, with the European Parliament and the Council aiming to reach political agreement by early 2027.



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