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Position Paper

BDEW on the Reform of the EU ETS 1

Assessment of the European Commission's proposals of 17 July 2026

The German Association of Energy and Water Industries (BDEW), Berlin, represents over 1,900 companies. The range of members stretches from local and communal through regional and up to national and international businesses. It represents around 90 percent of the electricity production, over 60 percent of local and district heating supply, 90 percent of natural gas, over 90 percent of energy grid as well as 80 percent of drinking water extraction as well as around a third of wastewater disposal in Germany.

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1 Executive Summary

On 17 July 2026, the European Commission presented its [proposals for the reform of the EU ETS 1](#). The reform proposals focus on stationary installations as well as aviation and maritime transport and are expected to take effect predominantly from 2031 onwards.

While the fundamental logic of the EU ETS 1 remains unchanged, the reform could result in a less pronounced increase in the CO₂ price compared with the trajectory under current legislation. The substantial reduction of the Linear Reduction Factor (LRF) weakens the long-term scarcity and investment signal and may particularly disadvantage companies that have already invested early in climate-neutral technologies. At the same time, it must be recognised that parts of the energy sector will continue to rely on fossil-fuelled generation assets during the transition. The extension of free allocation for industry serves to protect against carbon leakage, but at the same time exacerbates the distributional issue between sectors that benefit from relief and those that bear the costs. A longer period of free allocation also reduces EU ETS 1 auction revenues and may lead to additional public funding requirements for the industrial transformation. According to calculations, this could result in additional annual costs for the German federal budget of up to EUR 10 billion. **The reform of the EU ETS 1 must therefore combine long-term transformation signals with an economically viable transition.**

Furthermore, the negotiations on the reform of the EU ETS 1 should not result in any further postponement of the EU ETS 2.

From BDEW's perspective, the following key recommendations arise:

- › **The current Linear Reduction Factor (LRF) of 4.4% per year should, as a matter of principle, not be substantially reduced.** The LRF should be set independently of the outcome of the assessment of the effectiveness and availability of international credits, in order to increase transparency and predictability regarding the development of the Union-wide supply of allowances for market participants and to protect early movers.
- › The phase-out of free allocation must not proceed faster than the establishment of an effective carbon border adjustment mechanism that also addresses, in particular, the issue of exports.
- › **Linking conditionality to free allocation is politically understandable.** However, it should only be introduced once it has been ensured that carbon leakage protection will not be weakened as a result.
- › The **integration of international credits and permanent carbon removals** is generally welcomed, but the proposed design is not convincing. **Given the uncertainty surrounding their availability, international credits should not lead to an ex-ante reduction of the LRF. Their**

integration should be additional and should not result in a lower LRF. BDEW supports examining a mechanism that combines decentralised procurement with central volume control, thereby enabling a more efficient additional integration of credits. Should the Commission maintain its approach of linking international credits to a lower LRF, the LRF should be adjusted proportionally according to the actual availability of international credits. The currently envisaged LRF pathways of 1.7% and 2.7% merely represent the two extreme cases of full availability and complete non-availability.

- › The 250 million EUAs envisaged for the carbon removal purchasing programme should be taken from the existing Union-wide quantity of allowances under Article 9 and should not be created ex ante in addition to the cap. **The integration of permanent carbon removals must not lead to an ex-ante increase in the emissions budget.** Here too, uncertainty regarding availability must be addressed through a correction mechanism.
- › **The MSR reform should be implemented as proposed by the European Commission. However, if it becomes apparent that the MSR continues merely to withdraw allowances from the market while the release thresholds – as has been the case to date – are never triggered, it must be possible to adjust the MSR at short notice.** In any event, the MSR should remain a volume-based mechanism and should under no circumstances be supplemented by price triggers.
- › BDEW rejects rigid restrictions on the **use of funds falling within the remit of the Member States. National control over auction revenues should continue to be ensured**, as Member States must be able to support the transformation of their industries domestically. The principle that **EU ETS 1 revenues should be channelled back into decarbonisation should therefore be maintained.**
- › Where waste incineration is subject to carbon pricing, an EU-wide harmonised framework is preferable to divergent national rules. Distortions of competition and shifts in waste streams must be avoided.

2 Amendments to the ETS Directive

The following section assesses the Commission proposals amending Directive 2003/87/EC (EU ETS Directive). BDEW comments on the relevant amendments.

2.1 Article 1(12) – Amendment of Article 9: Cap and Linear Reduction Factor

Commission proposal: The European Commission proposes to increase the cap to account for certain maritime emissions, the inclusion of smaller ships between 400 and 5,000 gross

tonnage, and the inclusion of municipal waste incineration. In addition, the LRF is to be reduced to 3.7% from 2031 to 2035 and to 1.7% from 2036 onwards.

Assessment: The proposal retains the fundamental architecture of the EU ETS 1. At the same time, however, the substantial two-step reduction in the LRF proposed by the European Commission significantly reduces scarcity in the EU ETS 1 at the very core of the system.

The proposal therefore reduces the immediate pressure to cut emissions and, in combination with the integration of permanent negative emissions, shifts a larger share of the required emissions reductions into the future. The resulting postponement of net zero in the EU ETS 1 to around 2048/49 could particularly disadvantage companies that have invested in decarbonisation at an early stage, as the economic advantage of low-emission technologies over emissions-intensive installations would initially be reduced. At the same time, a flatter reduction pathway during the 2030s means that stronger emissions reductions would have to be achieved within a shorter period after 2040. This could increase adjustment pressure at a later stage and make achievement of the climate targets more difficult.

The energy sector is already investing substantially in the transformation today. The success of these investments depends to a significant extent on a reliable and credible long-term CO₂ price signal. At the same time, it must be recognised that parts of the energy sector will continue to rely on fossil-fuelled generation assets during the transition. The economic burden imposed on these assets by the EU ETS 1 must therefore not be disregarded, particularly with regard to security of supply and the timely development of new firm generation capacity. The reform must therefore combine long-term transformation and investment signals with an economically viable transition.

From BDEW's perspective, however, a structural reduction in the LRF is only of limited suitability for addressing short-term burdens on individual groups of installations, as it changes the scarcity signal across the entire EU ETS 1 and affects long-term investment decisions. Short-term burdens and potential risks to security of supply should therefore primarily be addressed through targeted instruments without further weakening the LRF of the EU ETS 1.

If the EU ETS 1 price signal is weakened, achievement of the climate targets will have to rely more heavily on support programmes, regulatory requirements and other individual instruments. Although investments in industry and the energy sector are already frequently accompanied by support instruments, a weaker CO₂ price signal can increase additional funding and financing requirements and reduce the market-based steering effect of the EU ETS 1.

At the same time, investment decisions may become more dependent on the design of individual support schemes, potentially creating additional dependencies and lock-in risks.

A further issue arises from the interaction between the reduced LRF and other flexibilities that alter the available emissions budget, particularly international credits and permanent carbon removals. The use of international credits may result in the net reduction contribution to the 2040 target that must be achieved within the EU falling from 90% to at least 85%. This reduces domestic mitigation pressure up to 2040, while the objective of climate neutrality by 2050 remains unchanged. The reduction pathway is therefore initially flattened and must become correspondingly steeper after 2040. Necessary emissions reductions are shifted into later years – their actual implementation may become more costly for the economy as a whole and may reduce the necessary pressure for transformation. At the same time, there is uncertainty as to whether international credits and permanent carbon removals will actually be available in the quantities envisaged, while the proposed LRF and emissions budget are already based on the use of these flexibilities. This undermines long-term planning certainty.

By contrast, BDEW considers the increase in the cap to account for emissions from newly included sectors to be appropriate.

Recommendations:

- › **The LRF should continue to ensure a credible and predictable long-term scarcity pathway.** Additional market liquidity should therefore, as far as possible, not be created through a permanent structural reduction in the LRF, but primarily through further development of the Market Stability Reserve and clearly limited additional flexibility options such as international credits and permanent removals – once their integration has been secured.
- › At the same time, the design of the transition must take into account that parts of the energy sector will continue to depend on fossil-fuelled installations until sufficient new firm generation capacity has been developed. The corresponding burdens should, however, be addressed through targeted measures, such as conversion to hydrogen, without structurally weakening the long-term scarcity and investment signal of the EU ETS 1.
- › BDEW would prefer to retain the current LRF of 4.4% per year. To provide liquidity, international credits and permanent removals should be integrated into the EU ETS 1 on an additional basis, also in order to relieve parts of the energy sector. BDEW furthermore recommends examining whether the market liquidity required during this period could also be increased through further development of the Market Stability Reserve instead of permanently and significantly reducing the Linear Reduction Factor.
- › **Should a reduction of the LRF be unavoidable,** the reduction should be kept as limited as possible. In any case, the LRF should be set independently of the outcome of the assessment of the effectiveness and availability of international credits under Article 9b, in order to increase transparency and predictability regarding the development of the Union-wide

quantity of allowances for market participants and to protect early movers. After 2040, a lower LRF of 1.7% would be appropriate in order to take into account that both the purchasing programmes for international credits and domestic permanent carbon removals end in 2040. An LRF of, for example, 3.7% from 2031 to 2035, 2.7% from 2036 to 2040 and 1.7% from 2041 onwards would correspond to reaching net zero in 2045. In other words, from 2045 onwards no further EU allowances would enter the market, with the exception of any remaining allowances from the Market Stability Reserve.

2.2 Article 1(13) – New Article 9b: International Credits

Commission proposal: From 2036 onwards, high-quality international credits are intended to compensate for part of the additional issuance of emissions allowances envisaged under the proposal. For this purpose, up to 260 million EUAs are to be taken from the auction volume for 2036 to 2040 and auctioned to finance the purchase of up to 260 million international credits from the overall volume of international credits integrated through the European Climate Law.

Purchases are to be carried out by a new central EU entity. This indirect integration is intended to compensate for the reduction of the LRF to 1.7% from 2036 onwards. A fallback mechanism provides for the LRF to be increased from 1.7% to 2.7% from 2036 if high-quality international credits are not available. Companies themselves will not be able to use international credits under Article 6 of the Paris Agreement for compliance purposes, and unused EUA revenues will be made available to the Industrial Decarbonisation Bank.

Assessment: BDEW generally welcomes the consideration of international credits, but criticises the associated ex-ante reduction of the LRF.

The additional emissions space in the EU ETS 1 created by the envisaged reduction of the LRF to 1.7% is therefore already based on the expected future availability of international credits. This weakens the scarcity signal of the EU ETS even though it has not yet been established whether the envisaged quantities of high-quality international mitigation outcomes will actually be available on time and in sufficient volumes. At the same time, this creates additional uncertainty for market participants regarding the long-term cap trajectory and future price developments.

BDEW sees two possible approaches:

Preferred solution: Improving the Commission proposal

As outlined above, BDEW does not support lowering the LRF through the ex-ante integration of international credits. If this type of integration is nevertheless implemented, BDEW believes that the binary logic governing the adjustment of the LRF should be revised. Under the current proposal, the availability or non-availability of even a single credit could determine whether the

lower LRF applies. If the envisaged contribution from international credits is only partially available, the LRF should also be adjusted proportionally. The proposed LRF pathways of 1.7% and 2.7% merely represent the two extreme cases of full availability and complete non-availability. A correction mechanism should therefore be introduced to compensate for any shortfalls in procurement through a corresponding adjustment of the LRF.

Alternative solution: Examine other integration options

From BDEW's perspective, the central procurement of international credits proposed by the Commission may have a significant disadvantage: if the EU acts as the sole purchaser, there is a risk that competition and price formation will be restricted and that international credits will consequently not be procured at the most cost-efficient conditions. At the same time, it is understandable that unlimited quantities of international credits should not be integrated into the EU ETS 1. Integrating very large volumes would undermine a robust price signal. BDEW therefore encourages the Commission to consider a different approach and proposes examining a model that combines decentralised procurement with central volume control. At the very least, consideration should be given to how the disadvantages of central procurement with regard to price formation can be mitigated.

Prepare the use of international credits at an early stage

Under both scenarios, possible use of international credits from 2036 onwards should already be prepared during the period from 2031 to 2035. In addition to high standards regarding quality, additionality and environmental integrity, the EU should in particular develop cooperation with countries that have ambitious and credible Nationally Determined Contributions (NDCs), suitable institutional frameworks and existing or prospective strategic energy partnerships with the EU. The preparatory period should be used to align long-term climate strategies, national priorities and strategic energy partnerships with potential Article 6 cooperation, to establish robust monitoring and accounting standards and to create reliable cooperation frameworks. This would make it possible to establish a robust pipeline of high-quality credits at an early stage while also providing a reliable demand signal for corresponding mitigation projects.

In addition, the Directive should include a further review mandate requiring the Commission, for example by the end of 2038, to assess whether high-quality international project credits should also be eligible beyond 2040 and whether the purchasing programme should be extended accordingly. This could provide a cost-efficient contribution towards achieving climate neutrality, with particular emphasis on compensating for hard-to-abate residual emissions.

From BDEW's perspective, the EU ETS 1 should be internationalised gradually through linking and the use of Article 6 credits.

Recommendations

- › **The reduction of the LRF should not be made dependent on the uncertain integration of international credits.** Instead of the current indirect centralised approach, BDEW would welcome the Commission examining an approach combining decentralised procurement with central volume control.
- › If the reduction of the LRF through the integration of international credits is maintained, BDEW considers a **binding and, as far as possible, automatic or ex-post correction mechanism** necessary. **If the envisaged contribution from international credits is only partially available, the LRF should also be adjusted proportionally. Develop high-quality supply at an early stage:** the EU should use the period from 2031 to 2035 to establish Article 6 partnerships with suitable strategic partner countries, robust monitoring and integrity standards and a pipeline of high-quality international credits for the period from 2036 onwards.
- › Consider continuation of international credits: the **Commission should assess, for example by the end of 2038, whether high-quality international project credits should remain eligible beyond 2040** and whether the purchasing programme should be extended accordingly.

2.3 Article 1(13) – New Article 9c: Permanent Carbon Removals

Commission proposal: Permanent CO₂ removals through bioenergy with carbon capture and storage (BioCCS) and direct air carbon capture and storage (DACCS) are to be integrated into the EU ETS. Under a purchasing programme covering the period from 2031 to 2040, the Commission is to centrally procure up to 250 million tonnes of certified removals. For this purpose, additional allowances are to be created and added to the cap ex ante. In addition, 10 million allowances from within the cap may be used to provide additional funding if required for the purchase of these removals. However, unused EUAs from the purchasing programme would be returned to the general cap volume for auctioning.

Installation operators may use removal certificates generated from their own biogenic emissions through BioCCS to compensate for their own fossil emissions under Article 14(1a), up to zero emissions. The creation of negative emissions or additional freely tradable allowances is not provided for. By the end of 2034, the Commission is to review, among other issues, the later direct use of permanent removals and the possible integration of natural sinks.

Assessment: BDEW generally welcomes the rapid integration of negative emissions, but considers the proposed design to require substantial adjustment.

Through central purchases of BioCCS and DACCS removals by the European Commission and the de facto ex-ante increase in the cap by a corresponding number of new allowances, the cap

would in future effectively be understood as a gross emissions space net of removals. This represents a significant systemic change compared with a pure emissions budget.

As with international credits, the planned removal volumes are already taken into account when determining the available emissions space and therefore result in an ex-ante increase in the cap. At the same time, additional EUAs are to be auctioned in order to finance the expected difference between the EUA price and the higher costs of permanent removals.

This may weaken the scarcity and price signal of the EU ETS. The draft Directive itself recognises that an ex-ante increase in the cap creates uncertainty regarding the net climate contribution of the EU ETS.

BDEW therefore considers a binding and, as far as possible, automatic correction mechanism necessary. If the planned removal volumes are not delivered in full, not delivered on time, or can only be realised at higher costs, the additional emissions space created should be reduced accordingly, in a similar manner to the mechanism for international credits. A mere review of the mechanism would not be sufficient. In addition, it must be transparently clarified who bears the costs of procurement. Since the costs of BioCCS and DACCS are expected to exceed the EUA price, the Commission proposal envisages auctioning further EUAs to finance this difference. This not only places emissions avoidance and permanent removal on an equivalent accounting basis; it also creates a state-organised support and procurement mechanism.

While central procurement can help ensure the quality of removals and can, in principle, be designed cost-efficiently through competitive procedures, it prevents a direct comparison of prices and costs between emissions avoidance and carbon removal within the EU ETS. There is therefore a risk that additional emission rights and public support are used for comparatively expensive removals even where direct emissions reductions would be more cost-efficient for the economy as a whole. The mechanism therefore does not automatically guarantee an optimal allocation of costs. Competitive tenders, clear cost ceilings and priority for cost-efficient direct emissions reductions over subsidised removal projects are required.

The provision in Article 14a concerning the use of operators' own BioCCS projects should not be restricted to compensation for "fossil emissions", but should cover all emissions subject to surrender obligations, including process emissions, for example from lime calcination, and emissions from "non-sustainable biomass".

It should furthermore be clarified that installation operators using their own BioCCS projects to compensate for fossil emissions may market any certified capture and permanent storage of biogenic emissions exceeding their own needs through other channels, for example through the planned purchasing programme. This is necessary in order to avoid inefficient incentives to undersize capture facilities, particularly for installations with mixed biogenic, fossil and process

emissions where BioCCS can be deployed alongside fossil CCS and the need to compensate fossil emissions may be limited or negligible.

Recommendations: BDEW generally supports integrating permanent negative emissions into the EU ETS. However, the proposed design should be adjusted in particular as follows:

- › **The 250 million EUAs envisaged for the purchasing programme should be taken from the existing Union-wide quantity of allowances under Article 9 and should not be created in addition to the cap.** The integration of permanent carbon removals must not lead to an ex-ante increase in the emissions budget.
- › **Introduce a binding correction mechanism based on the model of the MSR:** additional emissions space may only remain permanently available to the extent that the underlying BioCCS and DACCS removals are actually delivered on time and in the envisaged quantity. In the event of under-delivery, the additional EUA volume must be reduced automatically and proportionally. A complementary support mechanism, for example payments under a CfD, could also help ensure that the volume of removals required to compensate for the increase in the cap is actually delivered.
- › **Ensure cost and funding efficiency:** procurement of permanent removals should take place through competitive procedures and be subject to clear cost ceilings. Since the costs of negative emissions are likely to exceed EUA prices, it will be important for the market ramp-up of negative emissions to bridge this difference through additional instruments, for example a CfD. As CO₂ prices increase, the required level of support will decrease. The long-term objective must be for carbon removals to become economically viable within the EU ETS without state support.
- › **Allow broader use of operators' own BioCCS removals:** installation operators should be able to use their own certified BioCCS removals not only against fossil emissions, but against all emissions subject to surrender obligations, including in particular process emissions and emissions from non-sustainable biomass.
- › **Enable marketing of surplus removals:** certified BioCCS removals exceeding an installation operator's own compensation needs should be eligible for marketing elsewhere or for inclusion in the European purchasing programme. This would avoid incentives to undersize CO₂ capture facilities and facilitate efficient investment, particularly at installations with mixed fossil, biogenic and process emissions.

2.4 Article 1(14) – Amendments to Article 10: Auctioning and Use of Revenues

Commission proposal: The Commission intends to focus the use of national EU ETS auction revenues more strongly on the decarbonisation of sectors covered by the EU ETS. In future, Member States would be required to use at least 50% of their EU ETS revenues for priority areas, including renewable energy and grids, industrial decarbonisation and electrification, CCS/CCU, climate-friendly aviation and maritime transport, waste management, and research and innovation.

Compensation for indirect carbon costs should generally remain possible, but Member States should seek to use no more than 25% of their EU ETS 1 revenues for this purpose.

Assessment: The Commission recognises that transparency and effectiveness regarding the use of EU ETS revenues remain insufficient and rightly proposes several measures to improve them. The proposed clear priority areas for the use of EU ETS revenues are also generally welcome. At the same time, however, the proposal substantially weakens the existing earmarking of revenues. Since June 2023, 100% of Member States' auction revenues have already been earmarked for energy and climate purposes. By contrast, the Commission proposes making only 50% subject to mandatory use for the newly defined priority areas. The remaining 50% would therefore effectively be left at the discretion of Member States and could potentially be used for other budgetary purposes.

Furthermore, under the Commission proposal for the Multiannual Financial Framework, 30% of Member States' auction revenues would be transferred to the EU budget as own resources. This would correspondingly reduce the share of national revenues to which the 50% earmarking requirement applies. The Commission explicitly justifies this by referring to the need to finance repayment of NextGenerationEU without cutting other EU spending programmes or increasing Member States' contributions to the EU budget. EU ETS revenues would therefore de facto also be used to service and repay EU debt. This represents a significant departure from the current principle that EU ETS revenues should be used for energy and climate purposes and, in particular, to support those bearing the costs of CO₂ pricing. Greater transparency and clearer spending priorities are generally welcome, but should not come at the expense of the existing earmarking of revenues. BDEW is also critical of the provision that Member States should seek to use no more than 25% of EU ETS 1 auction revenues for compensation for indirect carbon costs. Such a blanket restriction does not adequately reflect the differing industrial structures of the Member States. It would also require Member States either to forgo compensation exceeding this level or to finance the additional amounts from general tax revenues, thereby putting these expenditures in competition with other areas of public spending.

In addition, the proposal does not sufficiently take into account either the expansion of sectors eligible for compensation or the increasing electrification of industrial processes. As electrification progresses, protection against indirect CO₂ costs is becoming increasingly important for the international competitiveness of European industry. A rigid quantitative restriction should therefore be avoided. It should also be critically assessed to what extent the increasing earmarking of EUAs for European support instruments reduces the auction volume available to Member States. National auction revenues remain an important instrument for financing the transformation and should not be excessively constrained by additional centralised EU funding mechanisms.

Recommendations:

- › A rigid restriction on the use of funds within the remit of Member States – for example for compensation for indirect carbon costs – should not be introduced.
- › **National control over auction revenues should continue to be ensured and should not increasingly be shifted to EU level**, particularly in light of the proposed 30% transfer to the EU budget. Member States must be able to support the transformation of their industries domestically.
- › The relevant State aid guidelines should also be extended beyond 2030 without limiting the share of auction revenues that Member States may grant to energy-intensive industries.
- › Greater transparency and clearer spending priorities are generally welcome, but should not come at the expense of the existing 100% earmarking of revenues.

2.5 Article 1(15) – Amendment of Article 10a: Free Allocation

2.5.1 Free Allocation and CBAM

Commission proposal: The Commission proposes to continue free allocation beyond 2030. For CBAM sectors, the phase-out of free allocation is to be slowed down and the phase-out of the CBAM factors extended until 2037. Further amendments to the benchmark system and the conditions governing free allocation are addressed separately in Sections 2.5.2 and 2.5.3.

Assessment: Given continuing carbon leakage risks, free allocation remains an important instrument for protecting the international competitiveness of European companies. At the same time, as the effectiveness of the CBAM increases, free allocation should in principle be phased out as early as possible. However, existing protection instruments must not be phased

out faster than an effective, administrable and circumvention-resistant carbon border adjustment mechanism can demonstrably be established.

This applies in particular to the still unresolved issue of exports. At present, the CBAM primarily protects sales within the European internal market. Export-oriented companies, by contrast, continue to face a competitive disadvantage in third-country markets where no comparable CO₂ costs apply. BDEW therefore welcomes the Commission's proposal to extend the timeline for phasing out free allocation.

In addition, WTO-compatible instruments should be examined to ensure carbon leakage protection for exports. One such option could be a "Climate Contribution" on CO₂-intensive basic materials. Such an approach could strengthen carbon leakage protection without completely eliminating the CO₂ price signal along European value chains. The application of the CBAM to electricity imports must also be designed in a practicable manner.

Short-term physical electricity flows are important for security of supply and system stability. Reporting, calculation and settlement requirements must therefore neither impede cross-border electricity trading nor create distortions in the European electricity market.

Recommendations

- › **Maintain effective carbon leakage protection:** free allocation should in principle be phased out as early as possible as the effectiveness of the CBAM increases. However, it must not be phased out faster than an effective, administrable and circumvention-resistant CBAM can demonstrably be established.
- › **Address the export issue:** WTO-compatible instruments must be developed to avoid carbon leakage for exports to third countries without comparable CO₂ pricing. In particular, a "Climate Contribution" on CO₂-intensive basic materials should be examined.
- › **Ensure practicable application of CBAM to electricity imports:** the application of CBAM to electricity imports must not impede short-term cross-border electricity flows. Reporting, calculation and settlement requirements must be designed so that electricity trading, security of supply and system stability are not adversely affected.

2.5.2 Benchmarks after 2030

Commission proposal: The European Commission proposes several adjustments to the benchmark system for free allocation after 2030. The maximum annual reduction rate used when updating benchmark values is to be reduced from 2.5% to 2%, while the minimum annual

reduction rate of 0.3% would remain unchanged. At the same time, the possibility of establishing sector-specific fuel and heat benchmarks is to be introduced. The basic principle of basing benchmarks on the most efficient installations is to be retained. Furthermore, the buffer aimed at avoiding application of the Cross-Sectoral Correction Factor is to be increased from 3% to 4% of the allowances issued.

Assessment: BDEW generally supports continuation of an ambitious benchmark system and the existing approach of basing benchmark values on the 10% most efficient installations. However, benchmark updates must be transparent and adequately reflect the actual technical and economic decarbonisation options available in the respective sectors.

Reducing the maximum annual adjustment rate from 2.5% to 2% may limit abrupt reductions in free allocation and thereby improve planning certainty for installation operators. However, it must not structurally weaken incentives for the most efficient installations to reduce emissions. BDEW generally supports the possibility of establishing sector-specific heat and fuel benchmarks.

Greater sectoral differentiation can better reflect different technical starting points and decarbonisation pathways than uniform heat and fuel benchmarks. A prerequisite is a technology-neutral design that does not disadvantage, in particular, the electrification of industrial processes. Indirect CO₂ costs associated with electricity consumption should also be capable of being taken into account appropriately and in a legally robust manner. For district heating, sector-specific approaches could also help adequately reflect complex system structures and the integration of renewable heat and unavoidable waste heat.

The data basis used to update benchmark values must be transparent and representative.

Reference groups should include installations from different regions and climate zones as well as a sufficiently broad mix of technologies and fuels. Installations that are no longer covered by the EU ETS 1 during the relevant period should not distort future benchmark values. Alternative approaches to updating benchmark values, such as stronger sector-specific adjustments, may also be appropriate in principle, provided that they are transparent and reflect the actual decarbonisation potential of the respective sector.

BDEW supports increasing the buffer for avoiding application of the Cross-Sectoral Correction Factor from 3% to 4%. In addition, the existing New Entrants' Reserve should be available from 2031 onwards where necessary to prevent additional across-the-board reductions in free allocation through the Cross-Sectoral Correction Factor.

Recommendations:

- › **Update benchmark values ambitiously but realistically:** the basic orientation towards the 10% most efficient installations should be maintained. Benchmark updates must be transparent, based on robust data and adequately reflect the actual technical and economic decarbonisation potential of the respective sectors.
- › **Design sector-specific heat and fuel benchmarks appropriately:** greater sectoral differentiation should be technology-neutral and should in particular not disadvantage the electrification of industrial processes. Indirect CO₂ costs associated with electricity consumption should be capable of being taken into account appropriately and in a legally robust manner.
- › **Enable flexible sector-specific approaches:** alternative approaches to updating benchmark values should be possible where they are transparent and adequately reflect the actual decarbonisation potential and starting conditions of the respective sectors.
- › **Avoid application of the Cross-Sectoral Correction Factor:** BDEW supports increasing the CSCF buffer from 3% to 4%. In addition, the existing New Entrants' Reserve should be available from 2031 onwards for additional free allocation where necessary to avoid application of the Cross-Sectoral Correction Factor.
- › **Take different competitive and carbon leakage risks into account:** the benchmark system should reflect the differing starting conditions and competitive risks of sectors without weakening incentives to reduce emissions. Decarbonisation technologies with a high long-term climate impact should be appropriately reflected and incentives favouring emissions-intensive incumbent solutions should be avoided.
- › **Take account of the specific characteristics of district heating:** because of its local nature, district heating is not exposed to traditional carbon leakage risks. However, benchmark and allocation rules should ensure that district heating is not structurally disadvantaged compared with competing heating solutions. The interaction with the EU ETS 2 should be taken into particular account.

2.5.3 Conditionality

Commission proposal: The Commission proposes to link free allocation more closely to decarbonisation requirements in future. For the majority of affected installations, allocation would be linked to an installation-specific decarbonisation plan. Upon submission of such a plan, 80% of the envisaged free allocation would initially be granted. The remaining 20% would only be

allocated after successful implementation of the measures set out in the plan within the respective five-year period.

Pooling between several installations would be possible in order to meet the requirements. The 10% most efficient benchmark-setting installations would be exempt from the additional conditionality. An exemption is also envisaged for installations at which a decarbonisation project supported through the Innovation Fund, Investment Booster or Industrial Decarbonisation Bank is already being implemented. The new requirements would in principle also apply to EU ETS installations supplying heat or cooling to district heating and district cooling systems.

Assessment: The Commission's objective of creating stronger incentives for industrial decarbonisation efforts is understandable. However, BDEW sees a risk that the additional requirements could weaken carbon leakage protection because they effectively amount to an investment obligation. If conditionality is introduced, it should therefore in any event be targeted, proportionate, technology-neutral and low in administrative burden. Existing support instruments and free allocation should complement one another without creating duplicate structures or contradictory requirements. It is also positive that the 10% most efficient benchmark-setting installations, as well as installations implementing a decarbonisation project already supported through the Innovation Fund, Investment Booster or Industrial Decarbonisation Bank, are to be exempted from the requirement to prepare a separate decarbonisation plan. This can help avoid duplication.

The new requirements would in principle also apply to installations supplying heat or cooling to district heating and cooling systems. In Germany, however, these installations are already subject to decarbonisation planning requirements under the Heat Planning Act (Wärmeplanungsgesetz – WPG). There are also extensive requirements under the Energy Efficiency Directive which must be taken into account.

More generally, the decarbonisation requirements proposed by the Commission as a condition for free allocation should not be understood as investment support or as a substitute for suitable support instruments. Instead, they risk increasing EU ETS cost exposure and weakening carbon leakage protection. Where conditionality is maintained, it must be proportionate, technology-neutral, competitively neutral and low in administrative burden. In particular, permanently higher operating, fuel, electricity and maintenance costs must also be taken into account. However, recognising these costs must not lead to companies being required to implement specific low-carbon technologies irrespective of their economic viability. Otherwise, technologies with high ongoing operating costs – for example large heat pumps or hydrogen-based applications – could be disadvantaged compared with solutions primarily involving capital expenditure.

Investment and operating costs associated with the transformation should primarily be addressed through appropriate support instruments, particularly IPCEI funding.

Recommendations:

- › **The Commission's objective of strengthening decarbonisation incentives is understandable. Conditionality of free allocation should only be introduced once it has been ensured that carbon leakage protection will not be weakened.** It must not undermine carbon leakage protection or require companies to implement decarbonisation measures that are not economically viable. At the same time, the design should ensure that transformation incentives are maintained insofar as this is compatible with carbon leakage protection.
- › **Recognise operating and system costs:** in addition to investment costs, permanently higher operating, fuel, electricity, servicing and maintenance costs should be eligible as transformation expenditure.
- › **Enable flexible and low-bureaucracy compliance with conditionality:** requirements for decarbonisation plans and measures should be limited to what is necessary in line with European simplification efforts and should be designed flexibly. In particular, companies must not be required to switch to economically unviable decarbonisation technologies. Nor should allocation of the withheld 20% fail because of delays outside the installation operator's control, such as delays relating to permits, grid connections or funding decisions. Appropriate deadline extensions or alternative milestones within the operator's control should be provided for such cases. Where decarbonisation measures are required in return for free allocation, permanently higher operating, energy and maintenance costs should be taken into account alongside investment costs. Decarbonisation measures should not have to be implemented exclusively through the company's own investments at the site of the relevant EU ETS installation. Rental, leasing and contracting models, as well as suitable measures at other sites belonging to the company or – where there is a clearly attributable contribution – at sites of other companies within the EU, should also be recognised.
- › **Design staged allocation in a market-compatible manner:** linking part of free allocation to the implementation of defined decarbonisation measures is understandable in principle. However, the proposed system must not result in abrupt supply or demand shocks on the EUA market. Withheld or subsequently released allowance volumes should therefore enter the market as evenly and predictably as possible. Achievement of the relevant targets should be demonstrable on the basis of existing decarbonisation plans.

- › **Recognise existing transformation plans and projects already under way:** existing decarbonisation and transformation plans should be usable for the requirements of the “Invest in EU Decarbonisation Plan”. This applies in particular to existing planning requirements for district heating under the Energy Efficiency Directive and the German Heat Planning Act. Projects already approved or under implementation must also be recognised as fulfilling the conditionality requirements. Duplicate structures and retrospective additional requirements should be avoided.
- › **Exempt efficient district heating and cooling systems from additional conditionality:** installations supplying an efficient district heating or cooling system within the meaning of Article 26 of the Energy Efficiency Directive should generally be exempted from the obligation to prepare an additional installation-specific “Invest in EU Decarbonisation Plan”. These systems are already subject to separate regulatory transformation requirements.
- › **Alternatively, enable system-wide pooling for district heating:** where additional conditionality is maintained, compliance should be possible at the level of the entire heating or cooling system. All relevant investments in generation installations, networks, storage facilities and other heat sources and technologies – including large heat pumps, solar thermal energy, geothermal energy and industrial waste heat – must be taken into account. The decisive criterion should be decarbonisation of the overall system rather than exclusively the emissions trajectory of an individual EU ETS installation.
- › **Take affordability of heat into account:** the design of conditionality must not unnecessarily increase the costs of transforming district heating systems and thereby create additional burdens for heat customers. In particular, systemically appropriate decarbonisation measures must not be disadvantaged simply because they are implemented outside the individual EU ETS installation.

2.6 Article 1(16) – Amendment of Article 10b: Carbon Leakage Protection and District Heating

Commission proposal: Article 1(16) initially extends the existing carbon leakage provisions for sectors not covered by the CBAM until 2040. Free allocation will therefore in principle remain available to sectors particularly exposed to carbon leakage.

At the same time, free allocation for district heating supplies not exposed to carbon leakage is being redesigned. The current factor of 30% is to be gradually reduced after 2030 and phased out completely by 2040.

Assessment: The proposed complete phase-out of free allocation for district heating supplies by 2040 is problematic because the starting level differs substantially from that applying to other beneficiary sectors: the current allocation factor for district heating is only 30%. Decarbonising district heating systems requires substantial investment in generation facilities, networks, storage and other infrastructure. An early or complete withdrawal of free allocation may further increase transformation costs and these may be passed on to connected customers through heat prices. This is particularly relevant as long as comparable CO₂ costs do not apply outside the EU ETS and the necessary decarbonisation options are not equally available across all heat networks. As a general principle, BDEW supports phasing out free allocation as early as possible. However, the situation in district heating is fundamentally different.

The pathway for reducing free allocation should be aligned with the decarbonisation milestones under Article 26 of the Energy Efficiency Directive. These envisage a share of renewable energy and/or waste heat of 50% by 2035 and 75% by 2040 or 2045. In line with these milestones, the allocation factor could, for example, initially remain at 30% for the period from 2031 to 2035 and subsequently be reduced in stages. The timing should, as far as possible, be aligned with the reduction periods envisaged for the EU ETS 1. Under the fallback LRF pathway proposed by BDEW, possible periods would therefore be 2031–2035 and 2036–2040, followed by a phase-out by the mid-2040s.

In this context, BDEW also welcomes the fact that, if municipal waste incineration is included in the EU ETS 1, waste-to-energy installations supplying district heating are to benefit from free allocation. This is an essential component for the successful transformation of waste incineration installations. The planned gradual reduction to zero by 2040 is therefore all the more critical. As a fallback, the 30% free allocation for municipal waste incineration installations supplying district heating should be maintained until 2050.

Recommendations:

- › **The phase-out of free allocation for district heating should be reviewed and free allocation for efficient district heating and cooling systems should continue beyond 2040, or at least until clearly defined decarbonisation conditions have been met.** Free allocation should nevertheless generally be phased out as early as possible. Sector-specific transitional arrangements should only continue to the extent necessary to prevent carbon leakage or structural competitive distortions vis-à-vis alternative heating solutions not subject to comparable CO₂ costs.

- › The phase-out of free allocation for district heating should be aligned with the decarbonisation milestones under Article 26 of the Energy Efficiency Directive and, in terms of timing, should as far as possible be synchronised with the LRF periods.

2.7 Article 1(17) – New Articles 10cb to 10ce and the Industrial Decarbonisation Bank

Commission proposal: With Article 1(17), the Commission proposes a new European funding architecture for industrial decarbonisation. The Innovation Fund is to be continued and more strongly focused on the market deployment and scaling of low-emission technologies. In addition, a new central funding instrument, the Industrial Decarbonisation Bank, is to be created. Two phases are envisaged: An Investment Booster for 2028–2030 is to be financed by revenues from up to 400 million EUAs and should support, in particular, projects that can be implemented rapidly through fixed CO₂ premiums. A further 400 million EUAs are to be made available for a second phase covering 2031–2040, in particular for Carbon Contracts for Difference and CO₂ premiums. Part of the funds is to be reserved for lower-income Member States.

Assessment: BDEW welcomes the proposed funding architecture. It can help target the most cost-efficient industrial decarbonisation options. It is important, however, that no additional EUAs are introduced into the market and that existing EUAs are reallocated instead.

Recommendation: The Industrial Decarbonisation Bank should focus on the most cost-efficient decarbonisation options, in particular the electrification of low- and medium-temperature industrial heat.

2.8 Article 1(23) – New Articles 12a and 12b: Inclusion of Waste Incineration (Opt-Out Provision)

Commission proposal: The Commission envisages a gradual inclusion of municipal waste incineration in the EU ETS 1. The surrender obligation is to increase progressively and apply in full from 2034 onwards. Under certain conditions, however, Member States would be able temporarily to suspend inclusion. This would be subject to defined criteria, particularly regarding national CO₂ pricing and developments in recycling and landfilling.

Assessment: The inclusion of waste incineration installations in the EU ETS 1 requires a differentiated assessment. Operators of these installations – often acting as municipal contractors – have little ability to influence the level of fossil CO₂ emissions in the short term because these emissions are largely determined by the composition and volume of residual waste delivered to the installation. Carbon pricing at installation level should therefore not be overburdened

with expectations of immediate emissions reductions and must avoid undesirable waste-policy incentives, particularly shifts towards less climate-friendly disposal routes.

At the same time, if waste incineration continues to be subject to carbon pricing, whether at national or European level, there is a strong interest in an EU-wide harmonised framework. Compared with permanently divergent national carbon pricing systems, inclusion in the EU ETS 1 can limit competitive distortions between Member States and create a level playing field for waste incineration. The question of inclusion in the EU ETS 1 should therefore not be considered separately from existing national CO₂ pricing schemes.

A national opt-out provision could run counter to the objective of limiting competitive distortions between Member States and is therefore viewed particularly critically.

Recommendations:

- › **Ensure an EU-wide harmonised framework:** where waste incineration is subject to carbon pricing, this should as far as possible be harmonised across the EU. Inclusion in the EU ETS 1 is generally preferable to permanently divergent national carbon pricing systems, as it reduces competitive distortions and strengthens a European level playing field.
- › **Strictly limit national opt-outs:** national opt-outs must not result in different CO₂ costs and corresponding shifts in waste streams within the European waste market. Where opt-outs are provided for, they should be linked to carbon pricing of comparable economic effect and to relevant waste-policy conditions.
- › **Avoid undesirable waste-policy incentives:** the design of carbon pricing must respect the European waste hierarchy and must in particular not encourage the diversion of waste towards less climate-friendly disposal routes. The role of landfilling and more polluter-pays-based approaches to reducing fossil carbon inputs into waste streams should also be taken into account. These aspects are not yet sufficiently addressed in the Commission proposal.

2.9 Article 1(24) – Amendment of Article 14: Sewage Sludge and BioCCS Removals

Commission proposal: The Commission extends the monitoring and accounting rules under Article 14, in particular for biomass, mixed CO₂ streams and synthetic fuels. For biomass, zero-rating remains generally linked to the sustainability and greenhouse gas reduction criteria under the Renewable Energy Directive.

At the same time, installation operators would in future be able to use their own certified BioCCS removals to compensate for their own fossil emissions, up to a maximum of zero. This would not generate negative emissions or additional EUAs.

Assessment: BDEW sees a need for adjustment in both areas. Municipal sewage sludge contains a very high biogenic share. At the same time, demonstrating compliance with sustainability and GHG reduction criteria creates disproportionate administrative burdens due to its specific form of energy recovery. BDEW therefore explicitly calls for sewage sludge from municipal wastewater treatment **to be zero-rated without any additional requirement to demonstrate GHG reductions.**

With regard to BioCCS, restricting the use of removals to “fossil emissions” is too narrow. Eligibility should extend to all emissions for which a surrender obligation exists under the EU ETS, including, for example, process emissions, emissions from biomass that does not qualify for zero-rating and certain non-CO₂ emissions.

Recommendation:

- › BDEW calls for municipal sewage sludge to be assigned an emission factor of zero without any additional sustainability or GHG reduction demonstration. Operators’ own BioCCS removals should not be restricted to fossil emissions but should be eligible against all emissions subject to surrender obligations.

2.10 Article 1(35) in conjunction with Annex I – Scope of Waste Incineration

Commission proposal: From 1 January 2031, the Commission proposes to establish a separate EU ETS activity for waste incineration and waste co-incineration. Installations burning non-hazardous waste with a capacity exceeding three tonnes per hour would be covered. Chemical recycling would be excluded. The Commission deliberately bases the threshold on the Industrial Emissions Directive rather than on the 20 MW threshold otherwise commonly applied under the EU ETS.

At the same time, the existing exemption for municipal waste incineration units from the aggregation rule in Annex I would be removed.

Assessment: BDEW is critical of the three-tonne-per-hour threshold. This would also bring comparatively small installations below 20 MW within the scope of the EU ETS. It would particularly affect smaller industrial waste incineration installations and, in some cases, sewage sludge incineration installations with comparatively low CO₂ emissions. There are also questions regarding the delineation of installations using both hazardous and non-hazardous waste.

Recommendations:

- › Clear rules are required for installations using mixed hazardous and non-hazardous waste, and the 95% rule should also apply to newly included waste incineration installations.
- › The amended aggregation rule should only apply from 1 January 2031, at the same time as the actual inclusion of waste incineration in the EU ETS, and not already from 2029.

3 Market Stability Reserve and Total Number of Allowances in Circulation (TNAC)

The following section addresses the amendment of Decision (EU) 2015/1814 concerning the establishment and operation of a Market Stability Reserve (MSR) for the Union greenhouse gas emission trading system and amending Directive 2003/87/EC.

3.1 Article 2 – MSR and TNAC

Commission proposal: With Article 2, the Commission proposes to adapt the Market Stability Reserve to the declining future supply of allowances and the expected increase in scarcity in the EU ETS 1. First, calculation of the Total Number of Allowances in Circulation (TNAC) would be adjusted to account for allowances issued and verified emissions from international aviation for the period from 2012 to 2023. This would lead to a one-off reduction of approximately 173 million allowances in the calculated circulation volume.

In addition, the MSR parameters would gradually become more dynamic. From 2028 onwards, the MSR intake rate would be reduced from 24% to 12%. From 2029 onwards, the upper TNAC thresholds, currently between 833 and 947 million allowances, would be reduced by 4% annually. For the release of allowances from the MSR, a new buffer zone between 300 and 400 million allowances would be introduced below the 400 million threshold, allowing allowances to be returned to the market gradually rather than abruptly. In addition, automatic cancellation of MSR holdings exceeding 400 million allowances would be discontinued. These volumes would instead be retained as a reserve.

Assessment

BDEW generally welcomes the proposed further development of the MSR. As the cap continues to decline, the role of the MSR will also change. Whereas its main function to date has been to absorb structural surpluses from the market, the focus will increasingly shift towards ensuring sufficient liquidity in an increasingly scarce market while at the same time preserving a reliable scarcity and price signal. From today's perspective, the proposed adjustments can in principle reflect this changing role. It is important that the Commission underpins these

efforts and validates the underlying scenarios. The MSR must be developed into a rules-based liquidity buffer capable of credibly responding to future scarcity situations.

In particular, the reduction of the intake rate from 24% to 12% is welcome. With a continuously declining cap, maintaining a permanently high intake rate would risk withdrawing substantial additional volumes from an already tightening market and thereby tightening market conditions prematurely. A lower intake rate reduces this risk without removing the MSR's fundamental ability to respond to remaining surpluses.

The introduction of a gradual release mechanism within the 300–400 million EUA buffer zone is also positive. Instead of abruptly releasing large quantities of allowances, the MSR could respond more gradually to a declining TNAC. This would avoid sudden supply effects and improve predictability for market participants. The annual 4% reduction in the relevant thresholds is also intended to ensure that the size of the MSR remains aligned with the declining cap. This should prevent the reserve from becoming excessively large relative to the overall market in the long term while preserving the increasing scarcity signal of the EU ETS. However, it is currently not possible to predict with certainty whether allowances will ever actually be released from the MSR. Due to the substantial reduction in the release thresholds, which are themselves to become dynamic, it appears unlikely that allowances transferred into the MSR will ever return to the market. From BDEW's perspective, it must be ensured that in future the MSR no longer primarily serves to increase scarcity, but can instead provide liquidity on a rules-based basis.

The adjustment of the TNAC to account for historical net emissions from aviation is also appropriate. Without this adjustment, allowances would continue to be statistically counted as available to the market in the TNAC calculation even though they have effectively already been absorbed by aviation demand. This could lead to incorrect steering of the MSR. The one-off reduction of the TNAC by approximately 173 million EUAs therefore creates a more realistic basis for future management of the reserve.

Ending automatic cancellation of MSR holdings exceeding 400 million EUAs is also generally understandable. The allowances concerned would remain available as a reserve and could help stabilise the market during future periods of scarcity. In view of the significantly declining long-term supply of allowances, such a reserve could help mitigate extreme liquidity shortages and associated price volatility. However, this requires the interaction between transfers into the MSR and the return of reserve allowances to the market to function reliably and according to market needs.

Taken on their own, the proposed amendments form a coherent overall package. However, the MSR must not be assessed in isolation from the other elements of the reform. The

fundamental objective must be for the MSR to fulfil its role as a liquidity and stability instrument and not to be used primarily to reduce the TNAC.

Recommendation

- › **The MSR reform should be implemented as proposed by the European Commission. If it becomes apparent that the MSR merely continues to withdraw allowances from the market while the release thresholds – as has been the case to date – are never triggered, it must be possible to adjust the MSR at short notice.** However, the MSR should remain a volume-based mechanism and should under no circumstances be supplemented by price triggers.

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