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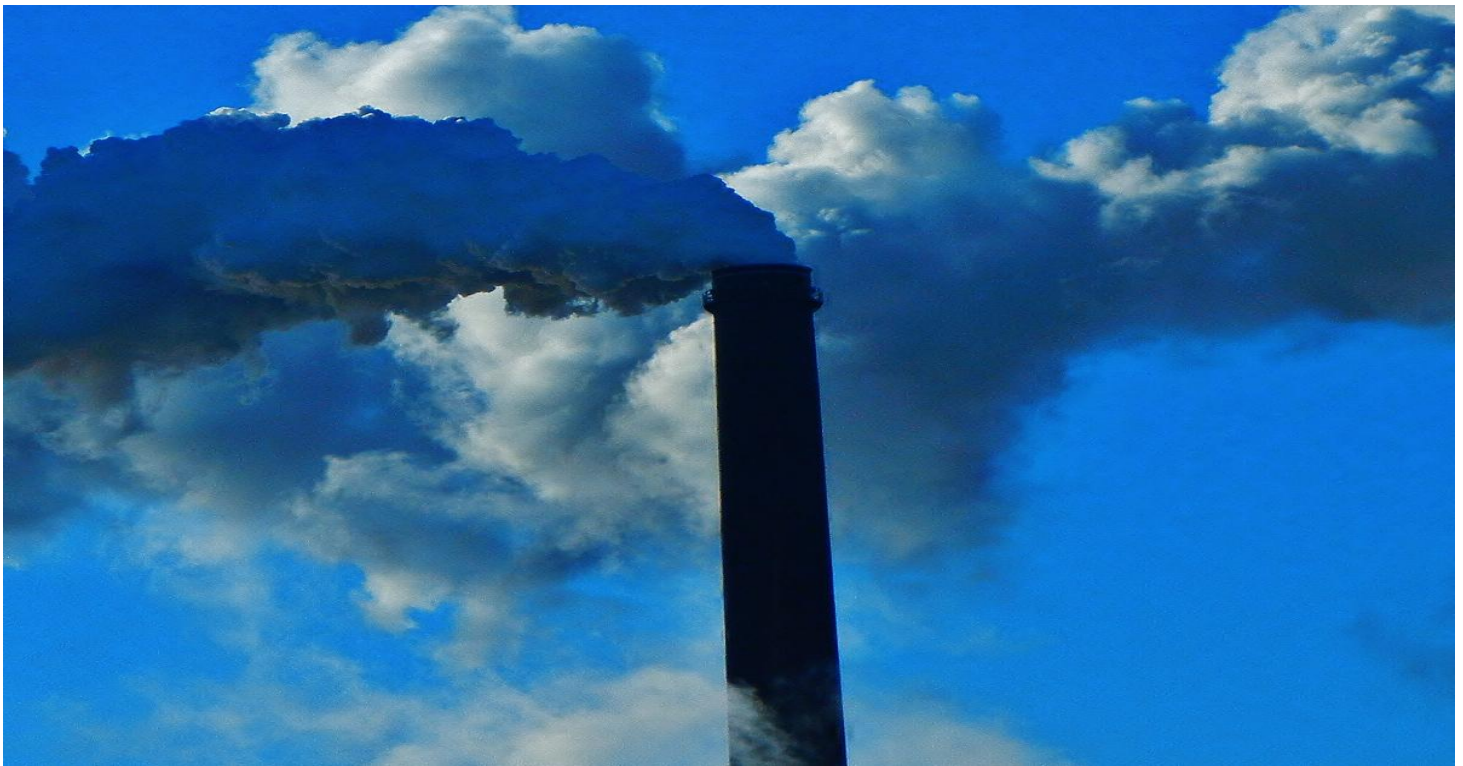
The European carbon market: (re)focusing the debate on investment in the EU's industrial transformation

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Last July, the European Commission presented its proposal to revise the European carbon market, and this is now at the heart of the debate on EU industrial policy. This reform marks an important step towards the Clean Industrial Deal's stated ambition to combine decarbonization with competitiveness. It seeks to reconcile seemingly contradictory demands: responding to short-term economic pressures, the need for industrial transformation, and preserving the credibility of the European Union's climate action. This challenge can be resolved by focusing the debate on the need to accelerate the modernization of the European industry towards electrification and decarbonization. The European Emissions Trading System

(ETS), which has been used with success by economic actors, can be a central pillar in achieving this, provided that the credibility of the emissions cap is maintained, the debate on the financing of industrial decarbonization is accelerated, and the conditionality framework for free allocations currently proposed is improved.

The [European carbon market](#) was created in 2005. Whilst Europe is a pioneer in this field, CO₂ pricing mechanisms have spread widely across the world ([IDDRI, 2025](#)). Setting a declining emissions cap that is known in advance allows a price for emissions to emerge through the gradual scarcity of pollution allowances on the market. Thus, when the trajectory for reducing allowances is credible in the long term, the ETS becomes a powerful tool not only for encouraging investment in decarbonization, but also for mobilizing financial resources through revenue from the sale of CO₂ allowances. These revenues can then be used to fund transition policies and stimulate productive investment.

This is exactly what happened when the EU adopted the [2050 climate neutrality target](#) and the subsequent Green Deal reforms, which significantly bolstered the credibility of the ETS trajectory following a period of several years (2013–2017) during which the European CO₂ price had fallen to a level that was merely an option for investors (€4 to €8/tCO₂) due, at the time, to the poor prospects for a reduction in the supply of allowances. In practical terms, these policy decisions have led to a sharp rise in the price of CO₂ within the ETS, which has been maintained since 2021 between €60 and €100/tCO₂, thereby providing a tangible incentive for European manufacturers to decarbonize. During this period, revenue from the sale of CO₂ allowances has also risen sharply, reaching over €40 billion per year from 2023 onwards—an increase of almost fourfold since 2018. The carbon market has thus become an indispensable economic compass in recent years for Europe's energy and industrial sectors.

The credibility of the emissions cap: a key factor in ensuring the ETS fulfils its economic role

The Commission is today proposing to reduce the rate at which the cap is lowered. The trajectory for the reduction in allowance allocations is set at -4.3% of average emissions from the covered sectors over the 2008–2012 period and at -4.4% from 2028 onwards. The Commission proposes reducing this rate to -3.7% for the period 2031–2035, then to -1.7% from 2036 onwards (or -2.7% if the EU does not make use of international carbon credits). The cumulative effect is significant, as it results in climate neutrality for the sectors covered by the ETS being postponed by nine years, from 2039 to 2048, and [increasing the carbon budget by +1.13 Gt CO₂](#), whilst other measures under consideration could also, depending on the options selected, increase emissions from energy production and industry by up to +2.9 Gt CO₂ by 2050, representing a +33% rise in the cumulative carbon budget. This increase in the overall supply of allowances and credits exerts downward pressure on the long-term price of carbon, although the market reaction has so far been limited due to the energy crisis. However, a weakened price signal reduces the economic incentives for manufacturers to invest in decarbonization solutions, as well as the revenue from the sale of CO₂ allowances for Member States and the EU.

At a time when the parameters of the reform are the subject of political debate, maintaining an emissions cap is a key condition for the ETS to fulfil its economic role. This must be assessed on two levels. On the one hand, the

ETS's ability to support and accelerate investment in the transformation of European industry within a timeframe compatible with the industry's long-term horizons and climate targets. There is an economic argument here for ensuring that the cap is not reduced abruptly from 2031 onwards in exchange for a sharper reduction in the number of allowances in a subsequent phase, as investments in decarbonization are needed now to set European industry on the path to transformation. Without them, the credibility of the EU's climate trajectory would be significantly undermined.

On the other hand, the impact on other economic sectors in light of the overall target for emissions reductions by 2040 (-90% compared with 1990) and by 2050 (climate neutrality). A reduction in the pressure on the ETS would automatically result in greater efforts being required from sectors outside the ETS, namely the buildings, transport and agriculture sectors. The European Commission's proposed post-2030 energy and climate framework, expected in early December, is likely to include climate targets for these sectors and should provide further insight into the credibility of the overall European climate architecture and the proposed trajectory for the ETS currently under discussion.

Financing the industrial decarbonization: a debate that needs to be accelerated

Another notable development in the Commission's proposed reform is the strengthening of support measures for investments in decarbonization, including: the overhaul and increased funding of European schemes to finance the industrial transition (the Investment Booster by 2030, followed by the [Industrial Decarbonisation Bank](#) from 2031); the earmarking of 50% of Member States' carbon revenues for ETS sectors; and a proposal for new conditions attached to the free allocation of allowances for sectors exposed to the risk of carbon leakage. The debate on these measures is inextricably linked, as two sides of the same coin, to the setting of the ETS parameters: on the one hand, the scale of the financial resources mobilized for industrial investment *via* the proposed measures depends directly on the parameters set by the ETS and, in particular, on the credibility of the emissions cap abovementioned; on the other hand, the impact of these mechanisms may be decisive in bringing about the low-carbon investments needed to reduce emissions from the sectors covered by the ETS.

Several aspects of the support schemes for industrial decarbonization deserve to be addressed, as they determine their effectiveness and, ultimately, political support for the reform of the ETS. Firstly, the financial envelope, the earmarking of revenues and the form of support for industrial decarbonization. The establishment of the Investment Booster and the Industrial Decarbonisation Bank should involve consideration of the financial architecture needed to free up financial resources immediately, in order to encourage large-scale investment in decarbonization. The option of increasing the availability of funds to support investment today by drawing on future ETS revenues, including through the use of debt, could be explored. Subsequently, based on an industrial strategy and thus clearly defined priorities, support mechanisms should be tailored to the characteristics of the sectors, technological solutions, infrastructure needs and cost structures ([Agora Energiewende et al., 2025](#)).

The key issue for industries subject to the ETS remains the cost differential between carbon-intensive and carbon-free products, which requires both a robust carbon pricing mechanism and measures to manage the variability of operating costs. The establishment of the Industrial Decarbonization Bank clearly points towards the introduction of carbon contracts for difference to reduce the risk associated with this cost differential; this

could be useful in mitigating the risks faced by manufacturers, but only from 2031 onwards. Discussions on this introduction could be brought forward, as investments need to be made now. The fixed premiums based on emission reductions announced in the Investment Booster would improve the economic case for low-carbon investments, but may not be sufficient to mitigate the risks associated with variable production costs (CO₂ prices or energy prices).

Finally, in an open economy, protection against the risk of carbon leakage is a key element in the effectiveness of a carbon pricing system and contributes to whether or not investments in industrial decarbonization are attractive. This issue is hotly debated, and the ongoing reform of the Carbon Border Adjustment Mechanism (CBAM) includes certain improvements for the value chains concerned. The question arises as to whether the scheme should be overhauled to protect sectors not currently covered by the CBAM. This is particularly the case for the chemicals sector (with the exception of ammonia production), which, by default, continues to rely on a model where carbon leakage risks are addressed through free allowances. However, this system risks being quickly overwhelmed by the inevitable decline in the availability of allowances to be allocated as the cap is reduced. Uncertainty regarding future arrangements could reinforce a wait-and-see approach to investment, particularly in an [adverse economic context for the sector](#).

Conditional allocation of free allowances: is the scheme in need of improvement?

Finally, the issue of conditions attached to the allocation of free allowances is a major point of contention in the debates. The Commission proposes making the allocation conditional on the submission of investment plans for decarbonization and their successful implementation. From 2031 onwards, 80% of the allocation would be paid out annually upon submission and approval of the investment plan, with the remaining 20% paid out five years later, provided that the investments have been made. This proposal is based on the observation that the industrial sector currently benefits from significant support through free allocation (between 35 and 39 billion euros in 2025) and that this funding does not sufficiently encourage investment in decarbonization ([Agora Energiewende et al., 2025](#)). A change in approach must therefore be carefully prepared.

Two approaches could be explored and combined: providing preferential access to funds from the Investment Booster and, subsequently, the Industrial Decarbonization Bank to companies that implement the investment plans they have declared in order to obtain the first part of free allowances; or bringing forward the allocation of free allowances to an industrial site that is the subject of investment decisions in low-carbon solutions.

Ultimately, the success of this reform of the European carbon market will have to be judged by its ability to accelerate the EU's industrial transformation. In an adverse economic context, it is by combining a credible price signal and climate framework with targeted financial support capable of reducing risk for investors that the EU can reconcile the modernization of its industry with its climate ambitions.