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The Price of Uncertainty

Even cosmetic reforms to emissions trading can jeopardize the structural integrity of Europe's climate policy architecture

Lukas Hermwille

The ongoing debate surrounding the reform of the EU Emissions Trading System (ETS) is unsettling markets. When policymakers compromise the stability of the CO₂ price, they do more than just threaten climate targets: they erode the bottom line of industrial frontrunners. Since political trust is a decisive determinant of the CO₂ price, short-term relief measures may ultimately prove costly for Europe as an industrial location in the long run.

On 11 February 2026, at the invitation of the European Chemical Industry Council (CEFIC), over 500 business representatives met in Antwerp with Ursula von der Leyen and a number of European heads of government. A year earlier, in the so-called *Antwerp Declaration*, these same companies had called on the EU to pursue a more active industrial policy and to strengthen competitiveness as a strategic priority. They called for a European industrial policy that complements the European Green Deal and strengthens clarity, predictability and trust in Europe and its industrial policy. Since then, the global competitive landscape has not improved; on the contrary. Donald Trump's aggressive tariff policy and intensifying geopolitical rivalries have actually exacerbated the situation for industry. Meanwhile, political calls are mounting not only for a complementary industrial policy, but the very architecture of European climate policy is being called into question. Against this backdrop, on 11 February, Federal Chancellor Friedrich Merz also took to the podium and questioned the European Emissions Trading Scheme. The ETS was introduced to reduce CO₂ emissions whilst enabling companies to produce carbon-free. "So, if this is not achievable and if this is not the right instrument, we should be very open to revising it or at least postponing it."¹

This announcement of a possible far-reaching reform or even a suspension of the scheme led not only to a sharp fall in the price of CO₂ allowances. At the same time, the share prices of companies such as Salzgitter and Heidelberg Materials, which as pioneers have already invested billions in converting their production processes to climate neutrality, also lost massive ground. This shows that the CO₂ price is not an isolated cost factor that industry simply wants to get rid of. It is also a reflection of the political uncertainty currently hampering investment in Europe. If policymakers call the instrument into question, they erode the pioneers' business case. The market has understood: without a reliable emissions trading system, investments in key green technologies lose their economic anchor.

¹ Quoted from Tagesspiegel Background Energy & Climate, 13 February 2026. <https://background.tagesspiegel.de/energie-und-klima/briefing/merz-irritiert-mit-aussage-zu-ets-1>

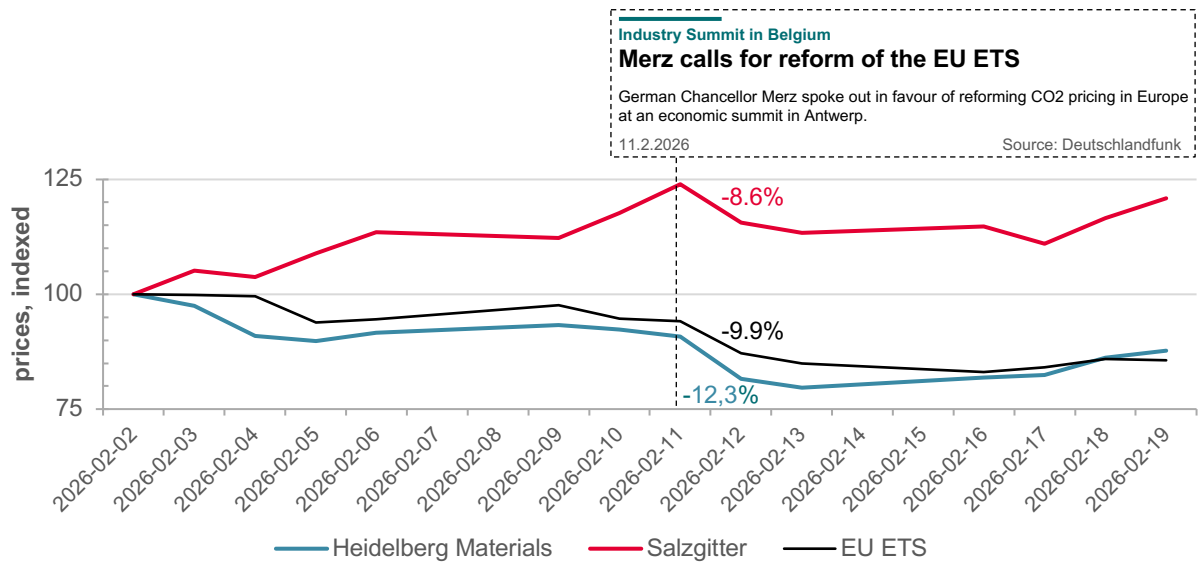


Fig.1 The CO2 price and share prices of Salzgitter and Heidelberg Materials react to Merz’s comments on EU emissions trading.

Confidence as a determinant of carbon prices

Although Friedrich Merz’s statements had no immediate impact on the fundamentals of emissions trading, the markets reacted to the political signals. The reason is that, in addition to the actual scarcity price, the potential failure of the policy instrument is always factored into the price. Formally speaking, the expected value of future ETS prices corresponds to the sum of the product of political credibility (q) and the scarcity price, as well as a probability-weighted scenario in which the ETS is politically abandoned or so watered down that allowances become effectively worthless. The probability of the political collapse of the ETS ($1-q$) corresponds exactly to the complementary probability of q .

The CO2 price as a confidence price: A formal representation

$E_t[P_{t+1}] = q \cdot P_{t+1}^{scarcity} + (1 - q) \cdot P_{t+1}^{collapse}$	P_t:	CO ₂ price in period t
	$E_t[P_{t+1}]$:	Expected value of the future price
	$P_{t+1}^{scarcity}$:	The hypothetical price in the next period given guaranteed scarcity (equilibrium price based on marginal abatement costs)
	$P_{t+1}^{collapse}$:	Price following the political collapse of the ETS, amounting to 0 or a very low single-digit price that no longer has any effective impact on the climate.
	q:	Political credibility: The probability that the instrument will remain politically stable and that allowances will retain their scarcity value ($0 \leq q \leq 1$).
	$(1 - q)$:	The probability of a political collapse (abolition of the ETS), in which the ETS price falls to zero.

If political confidence q falls – for instance, because leading politicians are openly considering delays or watering down the scheme – the weight of the collapse scenario automatically increases. The price is falling today, entirely regardless of how scarce the allowances actually are in physical terms. A falling price with a constant cap therefore signals not ‘economic success’, but simply the growing expectation of failure. This creates a toxic environment for capital decisions: anyone who has to write off billions in investments over decades cannot afford to rely on a system whose chances of survival on the market are in doubt.

Reform options put to the credibility test

Extension of free allocations

In the current debate, various levers are being discussed to ease the burden on industry, yet each of these options carries systemic risks. The more limited option is an extension or expansion of the free allocation of allowances to energy-intensive industries facing international competition. Historically, heavy industry companies have received a large share of allowances for free – significantly more than they have used.² Under current legislation, the plan is to gradually reduce these free allocations for products covered by the Carbon Border Adjustment Mechanism (CBAM) to zero by 2034 – initially in small steps, then much more rapidly from 2029 onwards. The levies that importers of energy-intensive products must pay under the CBAM are to be introduced in parallel to offset the disadvantage compared to international competitors. However, two unresolved issues remain: 1) The CBAM can only protect European industry in the domestic market; there is a lack of support for export-oriented companies. 2) So far, only relatively few sectors are covered by the CBAM; in particular, the chemical industry is missing, with the exception of fertilisers.

In the short term, reforming free allocation does not appear to cause too much damage to political credibility, as the absolute volume of emissions would remain unaffected. However, extending free allocation would entail a number of other drawbacks. For instance, it would undermine the hard-won compromise on the CBAM. The European Commission has consistently emphasised that CBAM is not a trade policy instrument, but a climate policy measure designed to create a level playing field between European producers and importers from third countries. If European producers continue to be subsidised through free allowances without the mandatory CBAM levies being adjusted for international competitors, the argument of a level playing field can no longer be upheld. Extending free allowances therefore jeopardises the international credibility of the CBAM and its compatibility with international trade law, and could thus provoke further conflicts.

Another disadvantage of this option is that extending free allocations would result in less revenue being available in the EU budget, which could otherwise be channelled back into the decarbonisation of industry via support programmes. In the fourth trading period of the ETS, the proportion of allowances to be auctioned is set at 57% of the total emissions cap. If a higher proportion of the available allowances is allocated for free, this share – and consequently the resulting revenue – would have to decrease. It is clear that a successful energy and industrial transition relies on subsidies and support programmes. These are financed to a not inconsiderable extent by revenue from the ETS. Given tight public finances, it is hardly plausible that other sources could compensate for the shortfall in revenue from ETS auctions.

Against this backdrop, the question arises as to what impact extending free allowances might have on the political credibility of the ETS. In the short term, it could boost the profits of the companies concerned and thus perhaps also defuse the current political conflict. However, it is not an option that improves long-term investment prospects in Europe, simply because emissions within the ETS as a whole must eventually fall to zero in order to achieve the goal of climate neutrality. By then at the latest, there can be no more allowances that can be allocated free of charge. Conversely, it is even conceivable that the measure merely postpones the political conflict rather than resolving it. For Salzgitter, for example, the announcement of the end of free allocations was a key trigger for considering a far-reaching transformation of its own production technologies.³ Other studies also show that free allocations significantly reduce the

² Marcu, A., Coker, E., Bourcier, F., Caneill, J.-Y., Schleicher, S., Hernández, F. L., Caruana, N., Chawah, P., & Finlayson, R. (2025). *2025 State of the EU ETS Report*. ERCST. <https://ercst.org/wp-content/uploads/2025/05/2025-State-of-the-EU-ETS-Report.pdf>

³ Leipprand, A., Ruß, M., Hermwille, L., & Posch, D. (2025). *Sustainable industrial policy: Combining prosperity, security and climate protection*. Bertelsmann Stiftung & Wuppertal Institute. <https://doi.org/10.11586/2025010>

incentives for companies to invest in the innovation and introduction of climate-friendly technologies.⁴ As a result, companies could delay transformative investments.

Adjustments to the reduction pathway

Proposals suggesting an extension of the reduction path in the EU ETS go even further. Since 2012, the cap for sectors covered by the ETS has been decreasing by a fixed amount each year, calibrated to ensure that the EU's binding climate targets for 2030 are met. Currently, this amount is calculated as 4.3% of emissions in a reference period (2008 to 2012); from 2028, it will be 4.4%. This results in a linear reduction path whereby the last allowances will be released onto the market in 2039.

Theoretically, it is conceivable to reform the reduction pathway so that allowances are made available to the market for a significantly longer period – for example, until 2050, when, according to the EU's targets, climate neutrality is to be achieved across Europe. However, if the total volume of emissions and thus also the climate impact are to remain constant, this is only possible with a convex reduction pathway. If, from 2030 onwards, emissions were to fall by approximately 18.7% year-on-year, this would result in cumulative emissions by 2050 that match the cumulative emissions under the current legislative framework. In the short term, however, emissions would have to fall much faster than they have done so far (see figure). In this respect, whilst this reform option is consistent in the long term, it is hardly suitable for reducing political pressure in the short term.

Alternatively, one could of course also adjust the linear reduction path so that new allowances are no longer made available on the market until later – around 2045 or 2050. Whilst such a postponement of the targets might alleviate immediate price pressure, it would simultaneously send the potentially disastrous signal that political climate targets are up for negotiation at any time in the face of resistance. This would inevitably lead to higher overall emissions from the ETS sectors which would have to be offset by a greater reduction burden on other sectors in order to remain on a compatible path to achieving the climate protection targets in 2040.⁵ However, sectors such as transport and buildings are already under enormous political pressure, so this seems unlikely. Should this compensation fail to materialise, the climate targets as a whole – and with them the EU's international credibility – would be called into question.

⁴ Teixidó, J., Verde, S. F., & Nicolli, F. (2019). The impact of the EU Emissions Trading System on low-carbon technological change: The empirical evidence. *Ecological Economics*, 164, 106347. <https://doi.org/10.1016/j.ecolecon.2019.06.002>, & Rogge, K. S. (2016). Reviewing the evidence on the innovation impact of the EU Emissions Trading System. In *Research Handbook on Emissions Trading* (pp. 161–194). Edward Elgar Publishing. <https://www.elgaronline.com/edcollchap/edcoll/9781784710613/9781784710613.00017.xml>

⁵ Figure 2 shows an adjustment to the linear reduction pathway from 2030 onwards. It would be conceivable to flatten the steep pathway only much later. This would result in significantly lower additional cumulative emissions, but the short-term impact on CO₂ prices would also be significantly lower.

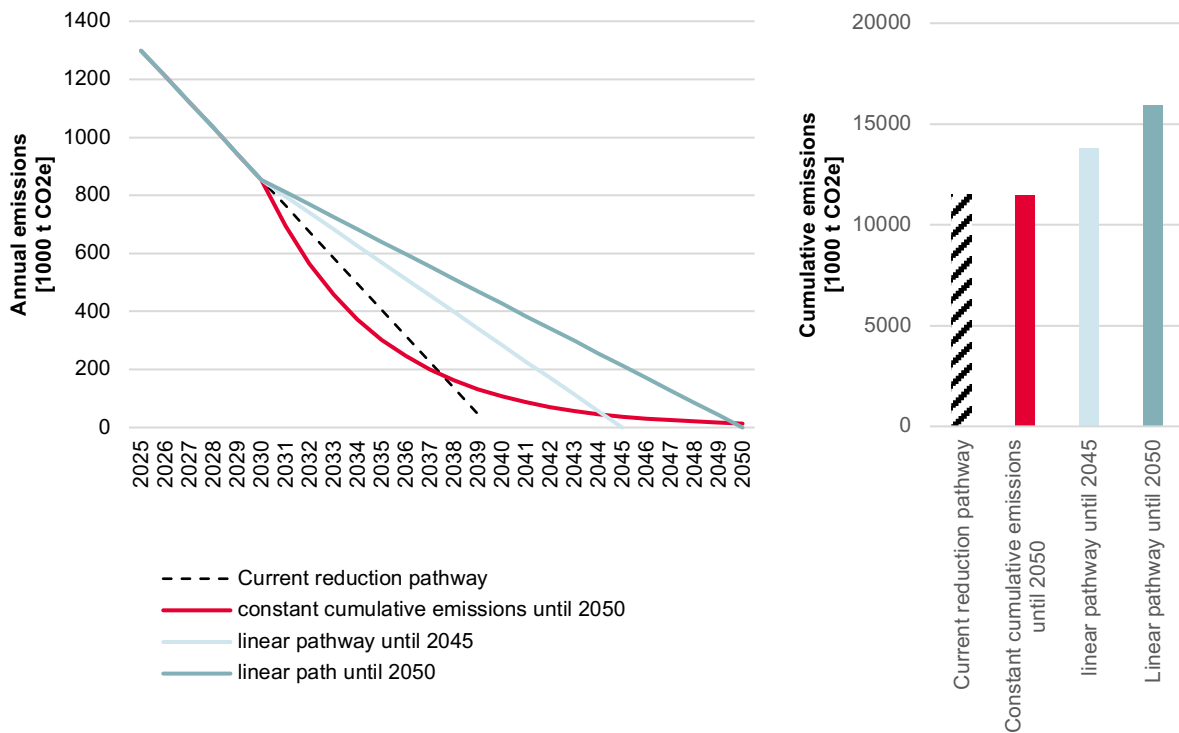


Fig.2 Illustrative representation of alternative reduction pathways.

Avoiding political feedback effects

If the linear reduction pathway is extended, the erosion of political credibility is evident, at least unless countermeasures are taken elsewhere. However, even an extension of free allocations can already generate political feedback effects that could jeopardise the stability of the European climate protection framework. Scientific literature and practical experience show that high levels of free allowances act as a sedative: they numb the pain but prevent the necessary healing. Companies that can rely on free allowances postpone far-reaching technological transformations. With a fixed emissions budget, every delay today makes the necessary transformation path steeper in the future. Those who ‘slow down’ today will have to ‘slam on the brakes’ tomorrow. This self-reinforcing effect massively increases political pressure in the future. If reductions have to be achieved in ever shorter timeframes, the risk of a disorderly system collapse increases. It stands to reason that economic pressure would then turn into political pressure. And the only way to release that pressure would then be to abandon the climate targets altogether.

In addition to the options considered here, there are further proposals, such as adjusting the market stability reserve, revising the benchmarks for free allocations, incorporating negative emissions or international reduction certificates, and returning the revenue from the ETS and CBAM to the affected industries. Although these options cannot be discussed in detail here, the same questions arise regarding their impact on the political credibility of the ETS.

Political credibility as a comparative advantage

We must acknowledge the reality: European heavy industry is facing an acute test of resilience. Global overcapacity and weakening demand in the automotive sector are putting the steel industry under pressure. In the chemical industry, structural disadvantages of naphtha-based production compared to ethane-based plants in the US or the Middle East are exacerbating the situation. Geopolitical risks such as the Iran war are also driving up energy costs. It is

understandable that policymakers are looking for levers to adjust in this crisis, and the ETS is one of the few that can be moved in the short term.

The core problem here is often not a lack of short-term liquidity, but the absence of a reliable long-term investment outlook in Europe. Whilst the CEOs of BASF and Evonik are publicly campaigning for reforms to the EU ETS or even its abolition, BASF is planning dividends and share buybacks totalling 12 billion euros for the period 2025 to 2028⁶ and Evonik has also hinted at boosting dividends to shareholders via share buybacks⁷. So, at least in the case of these companies, it is not a lack of funds but a lack of opportunities for forward-looking investments that is the issue.

The reform of the EU Emissions Trading Scheme should therefore be carefully considered: anyone who weakens the ETS to bolster margins in the short term risks eroding the system's political credibility. Rather, the aim of the reforms must be to improve the long-term investment outlook. Furthermore, following the landmark ruling by the German Federal Constitutional Court on the Climate Protection Act, it is clear that should emissions trading fail as a key market-based instrument, the Federal Government would be legally obliged to replace the targets with other, mostly less efficient regulatory instruments. The structural problems facing European industry would remain unresolved, and even greater political uncertainty would further hamper future investment.

⁶ <https://www.basf.com/global/en/media/news-releases/2026/02/p-26-020>

⁷ <https://www.evonik.com/en/news/press-releases/2025/05/Capital-Markets-Day-2025.html>