

# Signal without response: Why the EU ETS needs resolve, not redesign

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## In Summary

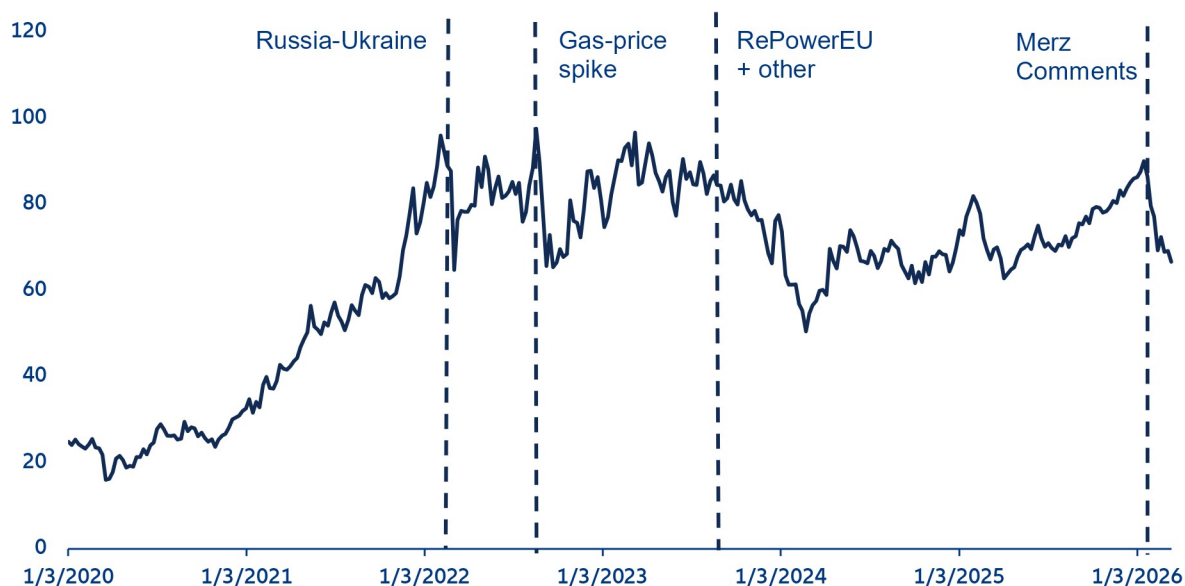
- **The EU Emissions Trading System (ETS) is at a political and structural inflection point, with allowance prices falling sharply by around -24% in the first two months of 2026. The conflict in Iran and associated energy price and inflation expectations have additionally spurred proposals to use the ETS as a lever for short-term price relief.** Unlike earlier episodes of price volatility rooted in energy-market fundamentals, the current turbulence reflects growing political questioning of the ETS's long-term design, compounded by concerns over industrial competitiveness as free-allowance phase-outs begin. Geopolitical pressure around Iran adds to this risk. The use of ETS revenues for price support or direct market intervention risk defeating the steering purpose of the system or creating dangerous lock-in effects.
- **Three ETS fault lines: free allocation has shielded more than 90% of industrial emissions from direct carbon costs but this is set to change; the ETS has driven substantial emission reductions in the power sector but not in industry and revenue recycling is falling short of its potential.** At current prices, full exposure would cost 0.9% of gross value added in the industry sector, a real burden for energy-intensive firms that cannot pass carbon costs through to customers given high energy costs, strong international competition and the limited offsetting potential of the Carbon Border Adjustment Mechanism (CBAM). Since 2005, power sector emissions have fallen by -54%, while industrial combustion emissions declined by a more moderate -33%. Renewables have made decarbonization viable at prices below EUR50/tCO<sub>2</sub>, while industrial options such as green hydrogen and low-carbon steel carry abatement costs well in excess of EUR100/tCO<sub>2</sub>. Persistent price uncertainty, with allowances oscillating in a EUR50–98/tCO<sub>2</sub> corridor since 2022, has further weakened the investment case for capital-intensive industrial transformation. Last, only 16% of recycled revenues flow back into energy and industry, the sectors directly covered by the ETS, while 51% is directed toward non-covered sectors. A cumulative EUR41bn went undeployed for climate action between 2013 and 2024, risking a financing trap where industry bears rising carbon costs without the capital needed to decarbonize.
- **ETS2 is better positioned than ETS1 but that advantage is eroding.** Unlike ETS1, where abatement economics were the binding constraint, low-carbon alternatives in transport and buildings are already cost-competitive. The remaining barriers are political and financial: EUR113bn in annual fossil-fuel subsidies undermining the price signal, policy reversals on fossil boiler phase-outs, unaffordable EVs and financing frameworks still unequipped to meet household-level transition costs at scale. With household exposure potentially reaching EUR420 per year by 2030, these are policy choices that should be addressed before the carbon price arrives in 2028.
- **The ETS does not need a redesign but rather targeted reforms to restore price credibility and close the investment gap.** Seven priorities stand out: establishing a credible long-run EUA price corridor; scaling up Carbon Contracts for Difference to bridge the abatement cost gap in hard-to-abate sectors; introducing binding revenue recycling standards linked to the new decarbonization bank; prioritizing shared infrastructure for CO<sub>2</sub> transport, hydrogen and industrial clusters; conditioning the free allowance phase-out on the availability of abatement technologies and transition funding; expanding CBAM to cover downstream sectors currently left exposed and ensuring ETS2 revenues are transparently earmarked for households most exposed to its regressive cost distribution.

## The ETS under fire: Market volatility and political pushback

**The EU Emissions Trading System (ETS) entered 2026 under unusual strain.** After reaching a two-year high of over EUR92/tCO<sub>2</sub> in January, the EU Allowance (EUA) price corrected sharply by -14% within the same month and another -10% in February, falling to approximately EUR69/tCO<sub>2</sub> (Figure 1). While the initial drop was triggered by geopolitical uncertainty over US tariffs, the future of Greenland and Iran, the second leg of the decline came amid growing political critique from member states, including Germany and Italy, which called into question not only the phase-out schedule of free allowances, but the long-term design of the mechanism itself. This turbulence arrives at a particularly consequential moment as the European Commission conducts its review of the ETS to determine whether its architecture remains fit for purpose in light of evolving market conditions and the EU's 2040 climate targets.

**The observed price volatility is not unprecedented within the ETS, but earlier episodes were driven by fundamentally different forces.** Between 2020 and 2022, allowance prices rose sharply, reflecting the post-Covid demand recovery, strengthened EU decarbonization ambition and an accelerated free-allowance phase-out schedule. The Russian invasion of Ukraine in February 2022 reversed this trajectory as anticipated gas supply disruptions curtailed industrial output and reduced compliance demand. Prices weakened further in 2023 amid declining industrial activity and the injection of additional allowances to finance RePowerEU. As Europe's energy dependence gradually shifted from Russian pipeline gas to US LNG, geopolitical risk remained the principal external driver of price formation, with US trade policy increasingly substituting pipeline politics as the key source of market uncertainty. Across these episodes, price movements were primarily rooted in energy market fundamentals or deliberate supply-side interventions, rather than in a broader questioning of the ETS's institutional design.

Figure 1: ETS allowance price and key market drivers (EUR/tCO<sub>2</sub>)



Sources: LSEG, Allianz Research

**The key distinction from earlier episodes lies in the structural changes to the ETS taking effect from 2026, compounded by broader concerns about industrial electricity prices.** From 2026 onwards, the free allowances allocated to European industry under the ETS begin to be phased out. The rationale was straightforward: as the Carbon Border Adjustment Mechanism (CBAM) enters into force to address international competitiveness concerns, the justification for shielding domestic industry through free allocation would progressively diminish, allowing the carbon price signal to drive further decarbonization. In practice, however, the transition has proved more contentious than anticipated. The CBAM, as finally adopted, covers a narrower set of sectors and a more limited range of emissions than originally proposed, leaving significant parts of European industry, particularly in downstream sectors, exposed to carbon costs without equivalent border protection. This concern is further reinforced by electricity prices that, while lower than their post-energy crisis peaks, remain structurally higher than those faced by key international competitors. At an EUA price of EUR65/tCO<sub>2</sub>, the carbon cost component of industrial electricity bills can reach up to 9% in the most carbon-intensive power systems, which disproportionately affects energy-intensive firms for which energy costs represent a larger fraction of total expenditure.<sup>1</sup>

**Against this backdrop, political reactions have been swift.** In Germany, the government announced plans to introduce a subsidized industrial electricity price of EUR0.05/kWh from 2026, roughly a third of the prevailing market rate, applicable to approximately 2,000 energy-intensive companies at an estimated fiscal cost of EUR3-5bn over three years. In Italy, a 2026 energy decree worth over EUR3bn proposed reimbursing gas-fired power plants for their ETS compliance costs, a measure that, given the role of gas in setting marginal electricity prices, would effectively decouple wholesale power prices from the carbon price signal. The European Commission has since opened a formal review of the measure's compatibility with EU state aid rules. Taken together, these interventions reflect a broader pattern in which the convergence of elevated energy costs and rising direct carbon-cost exposure is prompting member states to pursue unilateral measures that risk fragmenting the role of the ETS as a pan-European pricing instrument.

**The conflict in Iran and associated energy price and inflation expectations have additionally spurred proposals to use the ETS as a lever for short-term price relief.** These range from deploying ETS revenues for energy price support and adjusting the free allowance removal schedule to calls for direct market intervention to curb volatility. While some of these measures, such as the proposed ETS financed EUR30bn decarbonization booster, have their merits, others, such as the use of ETS revenues for price support or direct market intervention, risk defeating the steering purpose of the system or creating dangerous lock-in effects. The review of the ETS which was advanced to July 2026 is important and adjustments to the system can be warranted, however, the mechanism should not be misused as a short-term energy price management tool. For this purpose, other measures such as reducing non-steering levies on electricity including VAT, temporary state aid mechanisms for the most exposed energy-intensive industries, or targeted household transfers have a more direct and targeted impact on energy costs without undermining the carbon price signal the ETS is designed for.

### **Carbon costs in context: Limited exposure, rising trajectory**

**Despite the political concerns, the direct cost burden imposed by the ETS on European industry has thus far been limited.** As shown in Figure 2, more than 90% of Scope 1 emissions in covered industrial sectors have been offset by free allowance allocation, effectively shielding most of the sector from direct carbon-cost exposure while some companies even generated profits from selling surplus allowances on the market. Even in a theoretical scenario with full emission coverage, ETS compliance costs in industry would amount to approximately EUR29bn, or around 0.9% of gross value added (GVA) across European industry in 2024 (Figure 3). The power sector bears a considerably higher burden in relative terms, at EUR38bn or 11.3% of sectoral GVA.

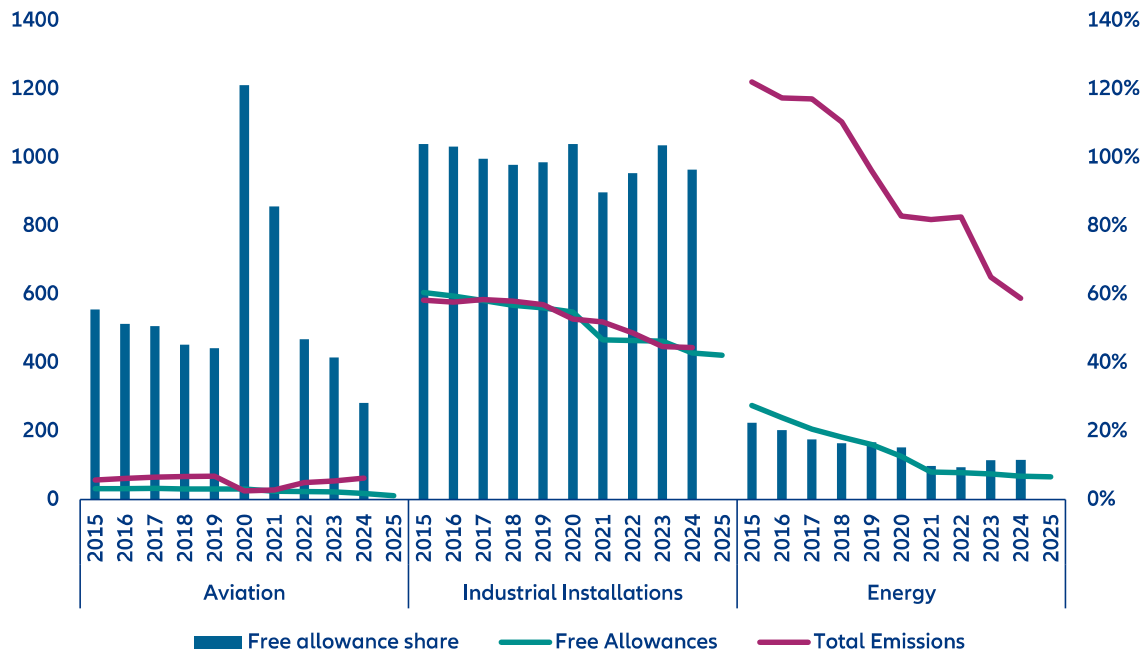
**The concern is therefore less about the current level of exposure than its trajectory.** Unlike utilities, industrial companies have limited ability to pass higher carbon costs through to consumers, making them more directly exposed to margin compression as free allowances are phased out. This is compounded by the gradual reduction in the overall supply of allowances, which will place upward pressure on EUA prices over time even

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<sup>1</sup> [ECB](#)

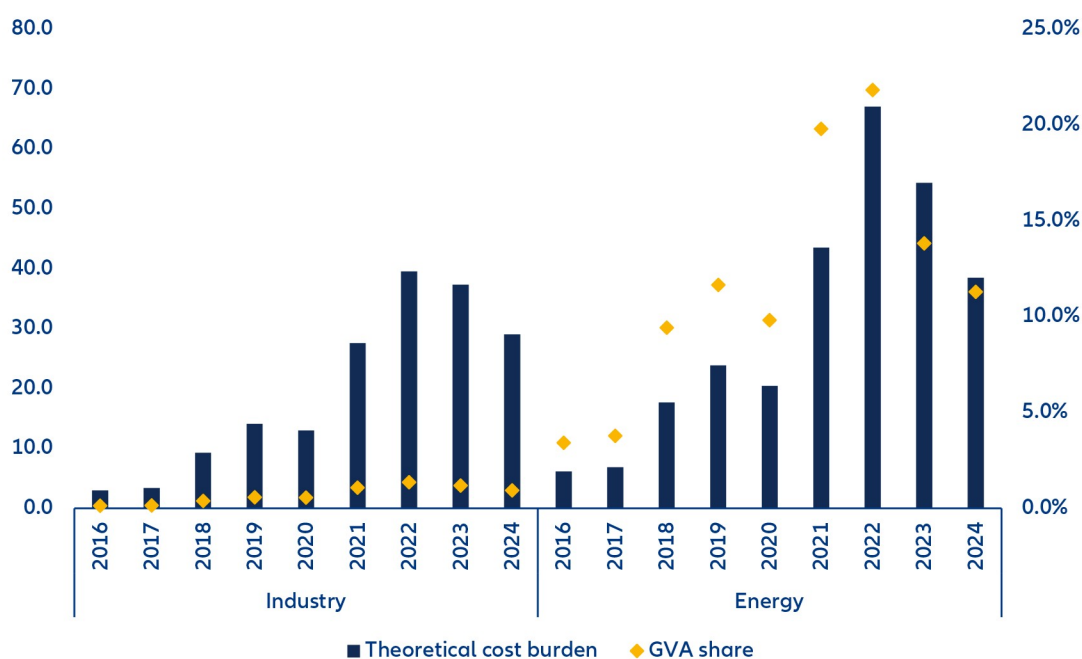
absent further policy changes. While the aggregate burden appears manageable at the economy-wide level, it is distributed unevenly across sectors and firm types, with energy-intensive industries facing the sharpest increase in net carbon costs as their allocation diminishes. A further structural issue is that the tradability of free allowances has not, in practice, generated the expected pace of industrial decarbonization. While the opportunity cost of holding rather than selling surplus allowances should in theory incentivize emission reductions, this mechanism has not translated into meaningful abatement investment across much of European industry. Understanding why requires looking beyond cost exposure to the sector-specific barriers that the carbon price signal has so far failed to overcome.

Figure 2: Sector emissions and free allowances (MtCo<sub>2</sub>, lhs) and free allowance share in total emissions (% , rhs)



Sources: EEA, Allianz Research

Figure 3: Theoretical cost burden under full exposure (EUR bn, lhs) and share in sector gross value-added (% , rhs)

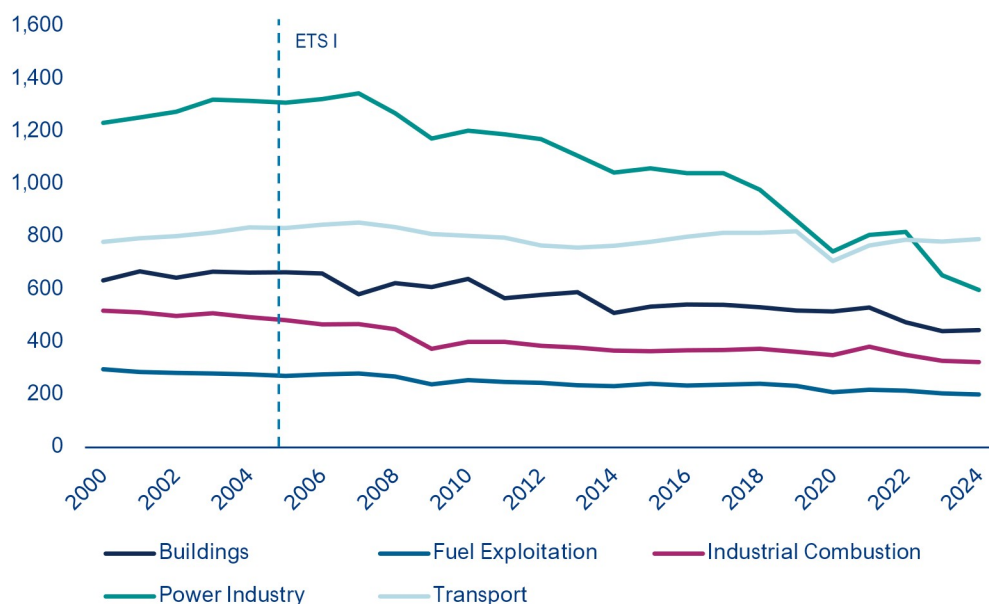


Sources: LSEG, Allianz Research

### A tale of two sectors: Why carbon pricing works better for power than industry

The EU ETS has proven effective as a carbon-pricing instrument, yet its decarbonization impact varies markedly across sectors. Since its inception in 2005, emissions in covered sectors have fallen by more than -48%, compared with only -19% in non-covered sectors (Figure 4). However, the reduction is largely driven by the power sector, where emissions declined by -54%, while European industrial combustion emissions experienced a meaningful but more moderate decline of around -33%, reaching 324 MtCO<sub>2</sub> in 2024. While free allocation is one mitigating factor in industrial decarbonization, firms retain incentives to abate as surplus allowances can be sold on carbon markets. The more fundamental constraints lie in sector-specific abatement economics. The power sector benefits from relatively short investment cycles, readily available low-carbon substitutes and competitive market structures that facilitate fuel switching. Industry, by contrast, faces longer capital stock turnover, technologically embedded process emissions and decarbonization options with higher marginal abatement costs – that is, higher costs for reducing an additional ton of CO<sub>2</sub>. These challenges are compounded by stronger exposure to international competition, which limits firms’ ability to pass carbon costs through to product prices. As a result, carbon pricing may exert weaker investment and abatement signals in trade-exposed industrial sectors, even when allowances remain tradable.

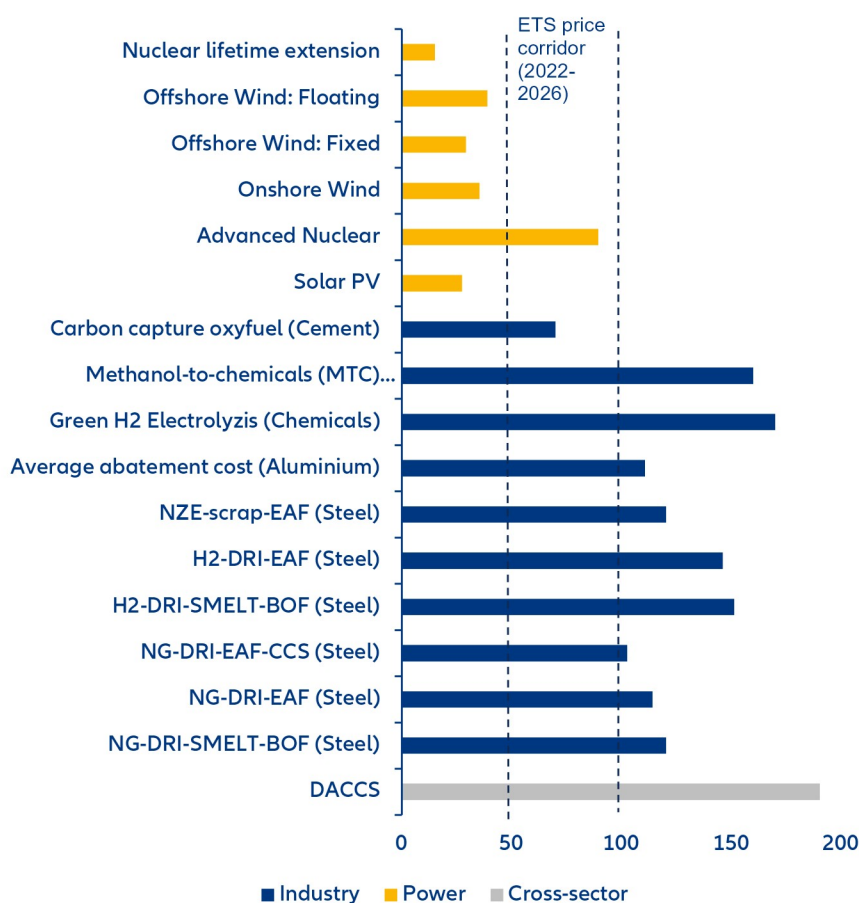
Figure 4: EU 27 emissions trajectory since introduction of EU ETS (MtCO<sub>2</sub>eq)



Sources: JRC EDGAR

**High marginal abatement costs and price uncertainty represent the two principal barriers to industrial decarbonization under the current ETS framework.** While the power sector has benefited from dramatic cost reductions in renewables that enable technology switching at prices below EUR50/tCO<sub>2</sub>, industrial decarbonization options such as green hydrogen, low-carbon steel and carbon capture typically carry abatement costs well in excess of EUR100/tCO<sub>2</sub> (Figure 5). This cost gap reflects both the technological complexity of transforming energy-intensive production processes and the fact that many promising abatement technologies have yet to reach commercial maturity, leaving firms exposed to considerable cost and performance risk. Persistent price uncertainty adds a further barrier: although the post-Covid tightening of allowance supply did generate upward price pressure, since the energy crisis of 2022 allowance prices have largely oscillated within a EUR50–98/tCO<sub>2</sub> corridor with considerable volatility. For capital-intensive investments with long payback periods and large upfront commitments, this unpredictability weakens the investment case precisely where long-term price credibility is most needed, and risks deferring the structural transitions that deep industrial decarbonization requires.

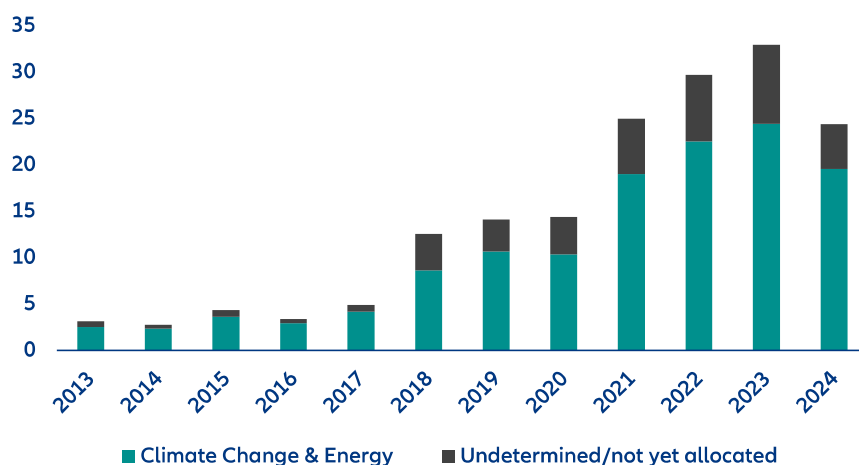
Figure 5: Abatement costs of selected decarbonization technologies by sector (EUR/tCO<sub>2</sub>)



Source: Allianz Research based on Agora & Wuppertal Institute [1, 2], MPP, EDF and IEA; Note: Abatement cost estimates can vary widely depending on sector, technology and region specific factors. Depicted values indicate cost averages.

**ETS revenue recycling represents a significant underutilized lever for bridging the industrial-abatement cost gap.** While the ETS obliges member states to reinvest allocated revenues in climate-related action, the mechanism underperforms in two key respects: the completeness of fund deployment and the strategic targeting of investments. Between 2013 and 2024, 13–31% of ETS revenues per year have remained unallocated or lacked a specific climate purpose, producing a cumulative deficit of approximately EUR41bn in effective revenue recycling (Figure 6). This structural shortfall limits the extent to which the ETS revenue mechanism can complement carbon price signals and support industrial transformation.

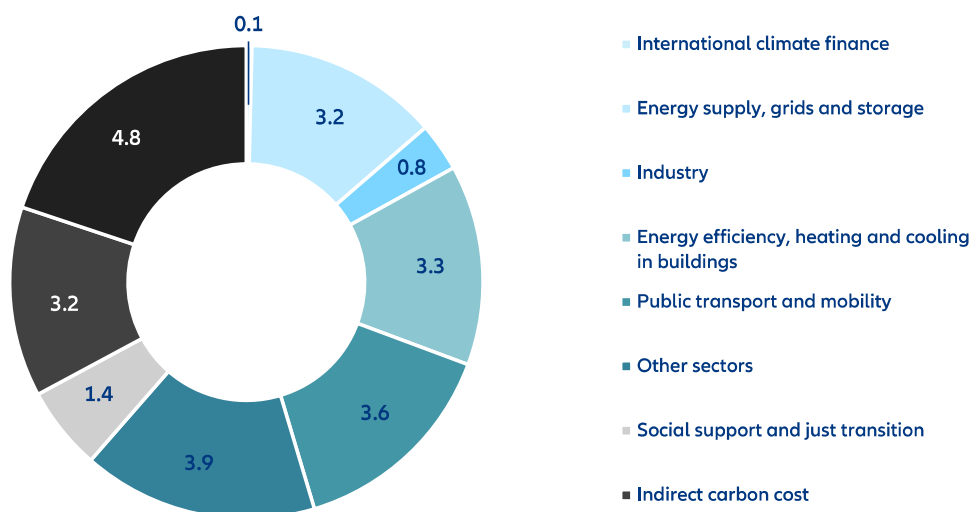
Figure 6: ETS revenue allocation gap (EUR bn)



Sources: EEA, Allianz Research

**Of the funds that are recycled, the sectoral distribution raises further concerns.** Only around 16% flows back into energy and industry transformation, the sectors directly covered under the ETS, while 44% is directed toward non-covered sectors such as buildings and transport (Figure 7). Although such cross-subsidization can be justified as a means of capturing near-term abatement opportunities and preparing these sectors for ETSII, an insufficient share returning to covered industries risks creating a financing trap, whereby firms bear the cost of carbon pricing without adequate access to the capital required to decarbonize. Equally important is the nature of recycling itself: in 2024, 13% of ETS revenues were directed toward "indirect carbon cost compensation" for energy-intensive industries, offsetting the very cost pressure the ETS is designed to create and thereby weakening the incentive to decarbonize. The same is true of support directed at technologies that have already reached cost-competitiveness, such as feed-in tariff schemes for mature renewables, where additionality is limited. To improve the efficiency of ETS revenue recycling, all revenues should be directed toward high-additionality decarbonization activities, ensuring covered sectors are not left underfinanced in the transition.

Figure 7: ETS revenue allocation by sector and purpose (%)

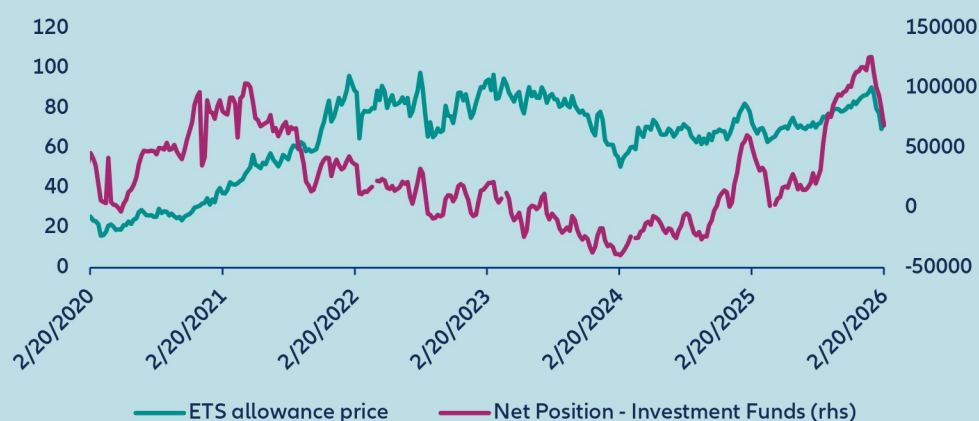


Sources: LSEG, Allianz Research

## BOX 1: What is the effect on capital markets?

The financial sector constitutes a primary participant in EU ETS secondary-market trading by volume. While non-financial corporates and compliance entities accumulate net long positions, banks predominantly serve as counterparties on the short side. Investment funds represent a smaller but notable participant cohort, exhibiting positioning dynamics that more closely reflect prevailing market expectations for price developments. Following the Russian invasion of Ukraine, funds rotated to net short positions, consistent with anticipated contractions in industrial output and EUA demand (Figure 8). This positioning reversed to net long in November 2024, before funds began unwinding exposure in early January 2025, contributing to the pronounced price decline observed over that period. Prior to the price decline, investment funds had built up a record net-long position.

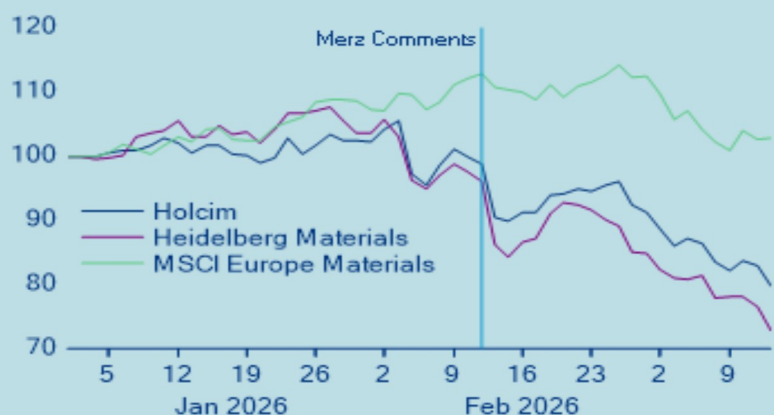
Figure 8: Investment funds' net positioning in EUA futures



Sources: Bloomberg, Allianz Research

The ongoing policy debate surrounding the future of the EU ETS has materially influenced investor expectations, particularly within the cement sector. Following the news of discussions on the future of the EU ETS market, the share price of Heidelberg Materials and Holcim, which are seen as transition leaders in the industry (see Transition Pathway Initiative assessment, for example), underperformed the broader materials sector (Figure 9). A prolonged phase-out of free allowances would disproportionately disadvantage companies that have already committed significant capital to decarbonization. Firms that invested early in low-carbon technologies or operational upgrades incurred substantial costs in anticipation of a tightening regulatory environment and rising carbon prices – an environment in which their abatement investments would generate a clear competitive return. An extension of free allocation effectively subsidizes higher-emitting peers, compressing the cost differential between decarbonization leaders and laggards and eroding the competitive advantage that early movers sought to secure. Simultaneously, lower prevailing CO<sub>2</sub> prices reduce the financial viability of capital-intensive abatement technologies such as Carbon Capture, Utilization and Storage (CCUS), for which the economic case depends critically on a sufficiently high and predictable carbon price signal. In aggregate, policy signals pointing toward a more lenient allocation regime risk undermining both the relative positioning of decarbonization leaders and the broader investment case for emission-reduction technologies across the sector.

Figure 9: Price reactions in European cement equities following statements on EU ETS reform



Sources: LSEG, Allianz Research

**EUA price dynamics represent a meaningful driver of equity returns in carbon-intensive sectors.** To quantify this relationship, sector index returns were regressed on both STOXX Europe 600 returns and the returns of rolled December EUA futures contracts from 2022 onwards. The results reveal a statistically significant and negative coefficient for EUA returns in the case of the STOXX Europe 600 Construction Materials Index and the STOXX Europe 600 Chemicals Index, indicating that rising carbon prices weigh on equity performance in these sectors. By contrast, no such relationship was identified for the STOXX Europe 600 Utilities or Basic Resources subindices. In the case of Basic Resources, this outcome is largely a function of index composition, given the limited share of steel producers among its constituents. For Utilities, the absence of a significant carbon price sensitivity is more structural in nature, reflecting the sector's substantial progress in decarbonization over recent years and the correspondingly reduced reliance on purchased allowances.

**For now the market seems to price in an extreme scenario of adjustments to the EU ETS for some of the affected companies rather than a delayed phase out.** Changes to the EU ETS are necessary to improve its effectiveness, but the phase-out of free allowances should continue. For investors aiming to decarbonize their portfolios and invest into transition leaders, these market reactions present a good opportunity to build up exposure to companies in hard-to-abate sectors that are actively decarbonizing their operations and that have credible transition plans.

## Bracing for impact: Getting buildings and transport ready for ETS2

**The EU ETS experience offers both a proof of concept and a cautionary tale for the next phase of European carbon pricing.** Confirmed to begin in 2028 following a one-year delay, ETS2 will extend carbon pricing to fuel combustion in buildings and road transport, sectors that together account for 52% of EU greenhouse gas emissions and where decarbonization progress has significantly lagged. Unlike ETS1, ETS2 will operate as a separate emissions trading system with its own distinct carbon price, reflecting the different cost structures and abatement dynamics of these sectors. Regulated entities will be fuel distributors rather than end-users, who will bear the cost indirectly through fuel prices. To limit affordability pressures during the start-up phase, ETS2 includes a transitional price cap of EUR 45/tCO<sub>2</sub> in 2023 real terms (approximately EUR59/tCO<sub>2</sub> in nominal 2028 terms), below which the carbon price is prevented from rising freely. The central lesson from ETS1 is that carbon pricing works when abatement alternatives are cost-competitive and enabling infrastructure is in place before the price signal bites. The cap is therefore an acknowledgment that those conditions are not yet fully met, and that the transition needs time to mature before the full price signal can do its work.

**Cost-competitive low-carbon alternatives exist in both sectors, but remain underdeployed.** In road transport, battery costs have fallen by over -75% since 2015, yet European consumers have not fully benefited. Pack prices in Europe remain around 56% above Chinese levels, and carmakers' focus on high-margin premium models pushed the average EU EV price up by EUR5,000 between 2020 and 2024 to EUR44,600.<sup>2</sup> Passing battery cost reductions through to vehicle prices, alongside a continued expansion of charging infrastructure, will be essential to make EVs cost-competitive before ETS2 enters into force. In buildings, accelerating energy-efficiency renovations, expanding heating networks in urban areas and scaling heat pump adoption are the central levers, yet all three face high upfront costs that current financing frameworks are not yet equipped to meet at scale.<sup>3</sup>

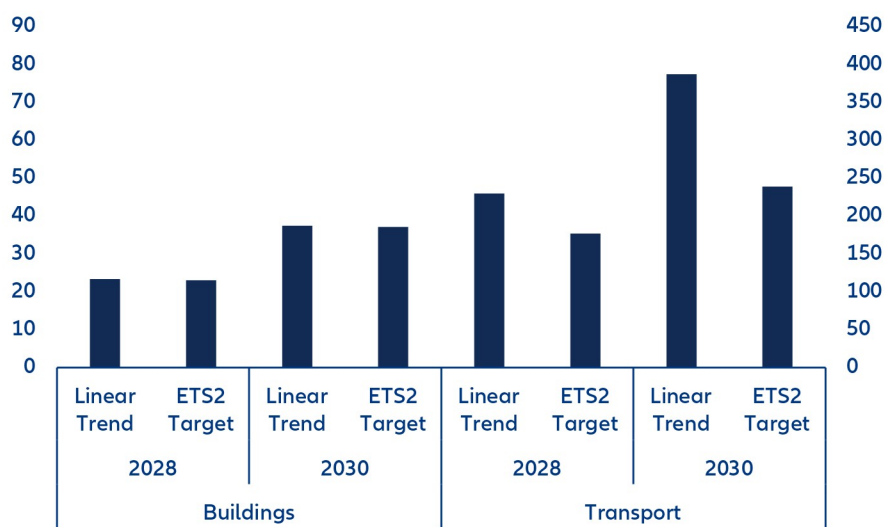
**Closing these gaps before 2028 is urgent as inaction carries a measurable cost.** In a pessimistic scenario with full sector coverage and only marginal reductions in emissions over the coming years, the annual ETS2 cost could be as high as EUR69bn by 2028 and EUR114bn by 2030 (Figure 10). Should ETS2 achieve its targeted 42% emission reduction against 2005 levels, these figures fall to EUR58bn in 2028 and EUR85bn in 2030. While this would alleviate some of the pressure on households, decreasing the cost burden by 15%-26%, the annual additional household expenses could come in as high as EUR420 per year by 2030. Reducing these costs is achievable, but hinges on adequate redistribution and well-designed supporting policies.

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<sup>2</sup> [BNEF and T&E](#)

<sup>3</sup> [For a more detailed analysis on heat pumps see \*The heat is on: Unlocking Germany's heat-pump potential\*](#)

Figure 10: Projected ETS2 revenues per sector: annual total (EUR bn; lhs) and per household (EUR; rhs) under full sectoral coverage



Sources: JRC EDGAR, Eurostat, Allianz Research; Note: For 2028 an initial maximum allowance price of EUR59/tCO<sub>2</sub> was assumed which increases to EUR100/tCO<sub>2</sub> in 2030; The ETS Target scenario is based on the 42% ETS reduction target for 2030 while the linear trend assumes an annual emission reduction rate aligned with the average annual reduction over the last 20 years

**Making ETS2 work requires addressing these conditions well before the carbon price arrives.** ETS1 revenues have already been partially directed toward buildings and transport, providing a foundation on which ETS2 can build, but the gaps remain substantial. Fossil-fuel subsidies across the EU still amount to EUR113bn annually, suppressing the relative cost of carbon-intensive heating and driving and blunting the investment case for cleaner alternatives. A credible partial phase-out would simultaneously strengthen price incentives and free up fiscal space for the infrastructure and household support the transition requires. Equally important is policy consistency as repeated reversals on fossil boiler phase-outs, subsidy schemes and regulatory timelines have fostered a wait-and-see mentality among households and investors, deferring the long-cycle decisions on heat pump installations, building retrofits and EV purchases that need to be made within the coming years.

**Social acceptability is the defining political challenge for ETS2, given that its costs fall more directly on households.** The aggregate macroeconomic impact is manageable: at a carbon price of EUR 59/tCO<sub>2</sub>, the estimated inflationary effect amounts to approximately 0.54pp, while the GDP impact is projected at around 0.02pp provided revenues are recycled rather than absorbed into general fiscal accounts.<sup>4</sup> However, these aggregate figures mask a regressive distribution, with lower-income households facing a disproportionate burden as energy and transport represent a larger share of their expenditure. Ensuring that revenues are recycled toward those most exposed, through direct transfers, subsidized access to low-carbon technologies and investment in shared infrastructure, will therefore be central to maintaining the public legitimacy on which ETS2's long-term viability depends.

### From price signal to investment signal: Seven priorities for ETS reform

**The EU ETS is fundamentally sound, but the political commitment to making it work has not matched its ambition; what the system requires is not a redesign but the resolve to make it effective and predictable.** The core challenge is not that the ETS is too stringent, but that it has failed to provide the certainty and complementary support that capital-intensive industries require to commit to deep decarbonization. That failure carries a forward-looking dimension: With ETS2 set to extend carbon pricing to buildings and road transport from 2028, the structural lessons of ETS1 – on price credibility, revenue recycling and enabling infrastructure –

<sup>4</sup> See [Climate policy: Europe's industrial shield or a drag on competitiveness?](#)

are also the design requirements that will determine whether the next phase succeeds. The following seven recommendations address this commitment gap and represent the priorities the Commission should act on in its 2026 ETS review:

- 1. A credible and predictable EUA price path is a prerequisite for long-term investment planning in carbon-intensive industries.** Many of the most consequential decarbonization decisions, such as switching to hydrogen as an industrial feedstock, involve long capital cycles and require sufficient and stable carbon price expectations to be financially justified. The Market Stability Reserve has broadly fulfilled its role in correcting surplus-driven price weakness, but should be refined to better contain sharp volatility and support a credible long-run price corridor. Publishing a transparent indicative price trajectory would materially reduce investment uncertainty and strengthen the carbon price as a basis for industrial decision-making.
- 2. Bridging the abatement cost gap requires scaling up Carbon Contracts for Difference (CCfDs) as a primary instrument for de-risking investment in breakthrough technologies.** CCfDs work by guaranteeing producers a fixed return for low-carbon production, paying out the difference between an agreed strike price and the prevailing carbon price when the latter falls short of what is needed to make the investment viable. This ensures that decarbonization investments in hard-to-abate sectors such as steel, cement, and chemicals remain financially attractive independent of carbon price volatility. Scaling up CCfD programmes and ensuring sufficient public backing to underwrite strike price commitments should therefore be a central priority of the ETS reform agenda.
- 3. Revenue recycling must be made more effective through binding standards that prevent underspending and ensure funds are directed toward activities where additional decarbonization can be achieved.** The newly established decarbonization bank provides a potential vehicle for channeling industrial transformation funding at scale, and its mandate should be explicitly linked to ETS revenue flows. Alongside this, a coordination mechanism is needed to prevent unilateral national measures, such as subsidized industrial electricity prices or ETS cost reimbursements, from fragmenting the integrity of the pan-European carbon price signal. The same discipline must apply to ETS2 revenues from the outset: the EUR113bn in annual fossil-fuel subsidies across the EU that currently suppress the relative cost of carbon-intensive heating and transport represent both a fiscal and a political opportunity. A credible phase-out would simultaneously strengthen price incentives and free up resources for the household support and infrastructure investment that ETS2 requires.
- 4. Decarbonization of energy-intensive industries also depends on shared infrastructure that no individual firm can finance alone.** Public investment should prioritize CO<sub>2</sub> transport and storage networks, hydrogen pipelines and the development of industrial clusters where infrastructure costs can be pooled. Without this foundation, even well-funded firms face structural barriers to acting on the carbon price signal.
- 5. The phase-out of free allowances should continue, but its pace must be made more explicitly contingent on the availability of abatement technologies, transition funding and infrastructure.** A phase-out that runs ahead of these enabling conditions risks creating a financing trap in which firms face rising compliance costs without a viable decarbonization pathway. The schedule should also incorporate a more systematic assessment of carbon leakage risk and competitive asymmetries, particularly for sectors not yet fully covered by CBAM.
- 6. The Carbon Border Adjustment Mechanism should be expanded to cover downstream sectors and indirect emissions currently left exposed by its narrow adoption.** As free allocation is phased out, border protection must keep pace to ensure that European industry is not placed at a structural competitive disadvantage relative to international competitors operating under less stringent carbon regimes. A broader CBAM scope is therefore not only a competitiveness measure but a precondition for the phase-out of free allocation to proceed without undermining the industrial base the ETS is intended to transform.
- 7. Social acceptability must be treated as a first-order design requirement for ETS2, not an afterthought.** Unlike ETS1, where carbon costs fall primarily on industrial firms, ETS2 will reach households directly through fuel prices for heating and road transport from 2028. The cost distribution

is regressive by nature – lower-income households spend a larger share of their income on energy and transport and will bear a disproportionate burden unless revenues are actively recycled toward direct transfers, subsidized access to low-carbon technologies and investment in shared infrastructure. Ensuring that ETS2 revenues are transparently earmarked for those most exposed is not merely an equity concern: it is the precondition for maintaining the public legitimacy on which the long-term viability of European carbon pricing depends.

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