



European Carbon: Repricing Risk or Repricing Reality?

European carbon has fallen sharply in recent sessions, reaching multi-month lows as political headlines, benchmark leaks and technical breaks combined with a rapid unwind of speculative positioning. The speed of the move has understandably unsettled the market.

Importantly, what has changed is **sentiment and positioning — not near-term structural fundamentals**.

What triggered the move

The decline was catalysed by a cluster of specific developments that increased perceived policy risk:

- Joe Delbeke, former Director-General of DG Climate Action and one of the architects of the EU ETS wrote in a statement that aspects of the ETS design — including the pace of free allocation phase-out and longer-term trajectory — may need to be reassessed to ensure industrial competitiveness. While Delbeke does not currently hold a legislative role, his historical association with the ETS lent weight to the remarks and contributed to market sensitivity.
- Friedrich Merz, Chancellor of Germany, stated publicly that the ETS framework must not undermine European industrial competitiveness and indicated that adjustments would be considered if necessary. Given Germany's political weight within EU climate negotiations, his comments were interpreted as raising the probability of future intervention or design changes.
- Leak of updated free allocation benchmarks, reinforcing market perception that industrials will receive more free allowances than initially expected.
- Significant speculative long liquidation, following elevated net positioning during the rally toward €90. Policy headlines acted as a catalyst for systematic de-risking.
- Spillover from UKA weakness and broader carbon market sentiment deterioration.
- Technical breaks, including a move below the 200-day moving average, which accelerated algorithmic and CTA-driven selling into relatively thin liquidity.

What has not changed

1. Free allocation remains within the cap

Any extension of free allocation would still come from within the existing cap. It does not increase the number of allowances in circulation.

Moreover, free allocation is constrained by CBAM compatibility, meaning it must be conditional and transitional rather than unconditional. The EU already has a precedent in the form of transitional free allocation linked to investment — particularly in parts of Eastern Europe, where energy companies receive allowances in exchange for upgrading generation assets.

In that sense, this is not new supply — it is a shift in cost distribution. The structural volume of allowances remains unchanged.

2. MSR redesign talk does not imply dilution

Joe Delbeke’s remarks also touched on the possibility of evolving the Market Stability Reserve into a more price-sensitive mechanism. Importantly, he referenced price levels materially above today’s market — in the €250–400 range — as indicative of stress.

This is not an argument for weakening the system at current price levels. Rather, it reflects a long-term discussion about how the ETS might behave in a fully hard-to-abate phase. No MSR changes are currently proposed for near-term implementation, and existing withdrawal mechanics remain legally binding.

3. Cap trajectory beyond 2040 is a sequencing debate

Discussion around smoothing or extending the cap beyond 2040 relates to the maturity of the system.

The EU ETS has already delivered substantial lower-cost abatement. Remaining reductions are concentrated in capital-intensive, globally exposed sectors. Extending the linear reduction pathway does not mean abandoning ambition; it reflects the shift from harvesting low-hanging fruit to managing structural transformation. Ensuring the longevity and credibility of the ETS as a rules-based framework reduces the risk of ad-hoc or surprise interventions later — a factor that ultimately supports market stability over the medium term.

Crucially, no change to the current cap trajectory has been legislated, and any such discussion would be part of a long-dated review cycle.

4. The “postponement” question — Germany’s role

Friedrich Merz’s comments about postponement are relevant but also confusing:

- The EU ETS is running for 20+ years, so any “postponement” can refer to a delay in the free allocation phase out or the post-2030 trajectory, rather than suspension of the system itself.
- As outlined before, such delay is in conflict with CBAM, another policy that is in place since 1 Jan 2026.

- While a formal ETS review is scheduled, any material change would require Commission proposal, Parliament approval and qualified majority support among member states. That process is multi-year in nature and does not imply near-term alteration of the current compliance framework.
- German industry has lobbied hard for a delay of the free allocation phase out in the last months, and it appears Merz is receptive of this. However, even though Germany has a strong say in EU politics, any adjustment would require broad consensus across member states with differing industrial and climate priorities.

In other words, while rhetoric around competitiveness is rising, the institutional inertia and legal framework of the ETS remain substantial constraints on rapid structural change.

Beyond the rhetoric, it is important to recognise the institutional constraints around ETS reform. The EU Climate Law, the operational launch of CBAM, the automatic mechanics of the MSR and member-state reliance on auction revenues materially limit the scope for abrupt intervention. Any meaningful change would require a formal Commission proposal followed by negotiation in Parliament and Council — a multi-stage process that reduces the probability of sudden structural dilution.

There is also a credibility constraint. The EU has embedded the ETS into its Climate Law framework, sovereign green financing strategy and CBAM design. A blanket postponement or dilution of cost internalisation would not only affect industrial incentives but could weaken CBAM’s legal defensibility, undermine investor confidence in the EU’s rules-based climate architecture, and introduce moral hazard for firms that have already invested under the current framework. This makes abrupt reversal economically and politically costly.

Market mechanics vs fundamentals

The recent move has coincided with a significant reduction in speculative length from elevated levels reached during the rally toward €90. Headline risk acted as a catalyst for an accelerated unwind. Such episodes historically influence **timing and volatility**, rather than the structural balance of the system.

Our view

Near-term fundamentals remain structurally tight, while policy headlines are driving volatility. With positioning adjusting and sentiment fragile, price action may remain erratic in the short term.

However, when volatility is driven by narrative rather than structural change, it can materially improve entry conditions. We view current levels as reflecting an expansion of political risk premium rather than enacted structural dilution, offering a more attractive tactical risk–reward profile than was available at recent highs — with the understanding that policy debate and positioning adjustments may continue to generate short-term volatility.



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