Danske Bank

24 April 2026

- ***In focus:*** *War-driven energy-price spikes have thus far generally led wealthier countries to move to support consumers through fuel tax cuts and subsidies, as opposed to change consumer behaviour. Against this backdrop, the flagship European Emission Trading System (ETS) has come under fire for increasing energy costs and negatively impacting the competitiveness of energy-intensive industries, just as the ETS approaches its 5-year review in July. While some governments want to materially weaken the system to cut near-term costs, others argue for keeping it intact and reforming it for operation beyond 2030 and delivering on 2040 climate targets. As such, EU's energy crisis response and the July ETS review becomes a litmus test for the European energy transition. Key focus areas of political discussion ahead of the review are 1) the ambition of the emission cap trajectory through the linear reduction factor (LRF), 2) the role of the market stability reserve (MSR) as a price stability buffer versus one that can suppress prices, and 3) how fast free allowances should be phased out, as carbon border adjustment mechanism (CBAM) scales. In short, going too far in weakening the system - especially by undermining the long-term carbon permit tightening path - would inject major policy uncertainty precisely when Europe needs a credible transition signal to accelerate decarbonisation and reduce fossil-fuel import dependence.*

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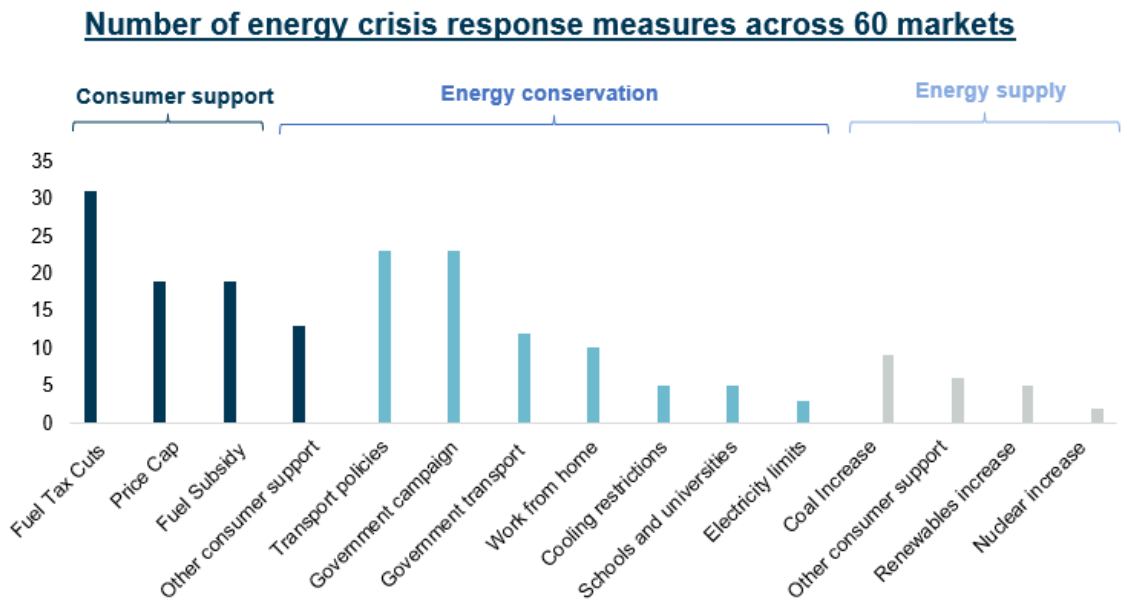
In focus: ETS revision is a bellwether for the European energy transition

We are now two months into the US-Israeli Iran war and a closed strait of Hormuz, repeatedly highlighted by IEA Chief Fatih Birol as the worst energy crisis in history. Prices for crude oil, refined oil products, natural gas and other fossil fuel derivatives are soaring due to supply constraints. Discussions on how to tackle the energy crisis has dominated political agendas across the world. Responses aggregated across 60 markets show an immediate focus on curbing price increases or reducing energy demand through changing consumer behaviour (see graph below).



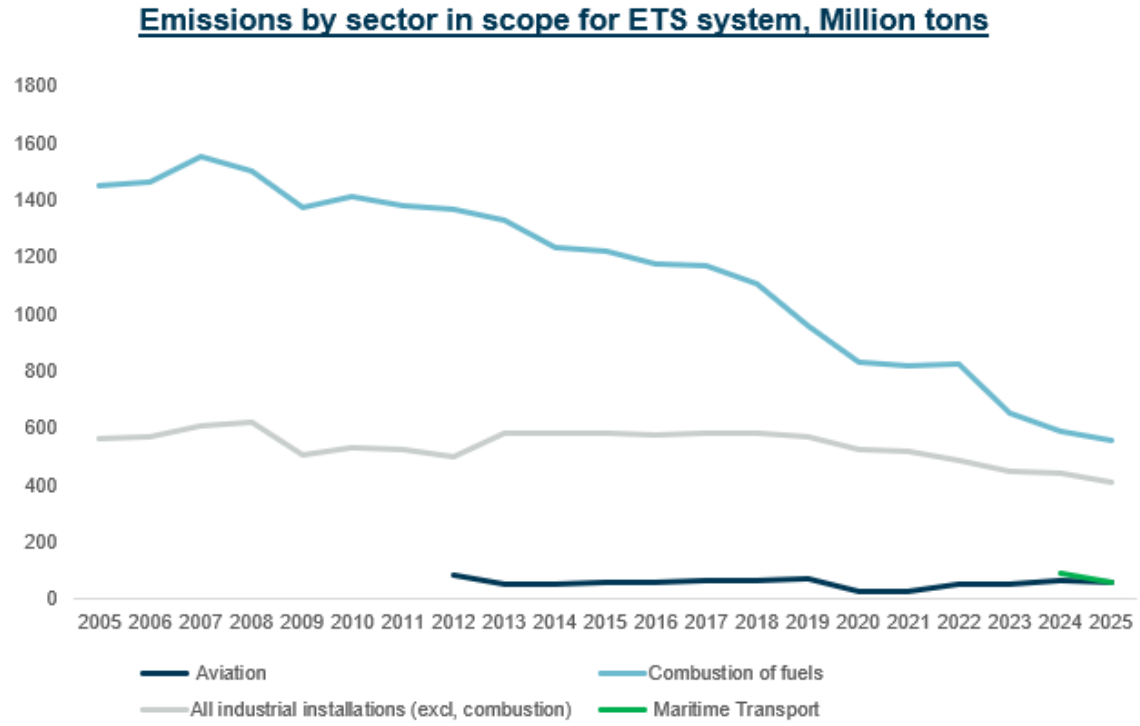
Source: Carbon Brief as of April 8th

Richer countries seem to thus far have focused on reducing prices through fuel tax cuts, price caps, or subsidies. Less wealthy countries that are less able to afford to pay exorbitant prices for fossil fuels have been more prone to already reduce energy demand through measures such as transport policies, work from home orders and shutting down public institutions. Reduced demand has been especially clear across Asia where physical shortages appear first due to Hormuz dependency and vicinity (also see our newsletter from March).

In Europe, initial efforts have focused on supporting consumer demand as opposed to effecting behaviour – though rapidly emerging physical supply constraints will force a greater focus on energy demand reduction should the crisis prolong. It is against this backdrop the European Emission Trading System (ETS) has come under fire for adding to increasing energy costs and impacting the competitiveness of energy-intensive industries. Coincidentally, the ETS is also due for its 5-year review in July, through which the European Commission will look at whether the system should be revised to be fit for purpose today and beyond 2030. Both near-term tweaks and long-term reforms will be of high importance to the European energy transition.

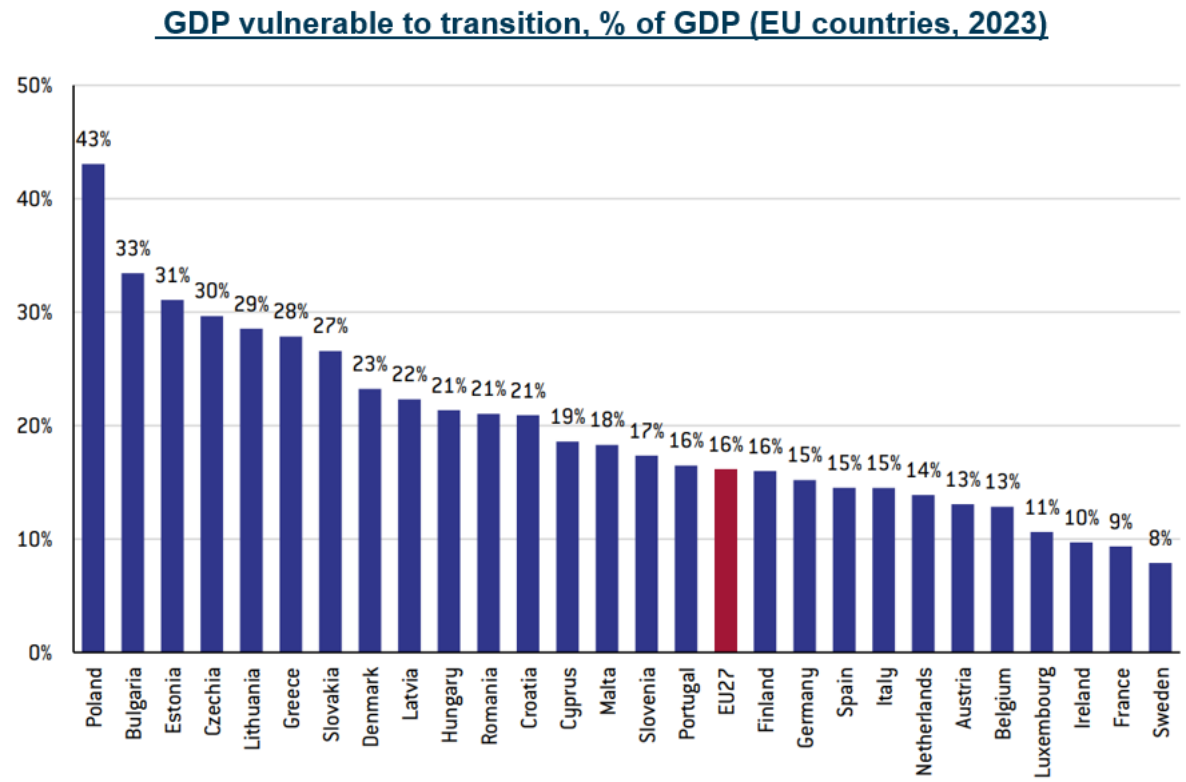
Europe's most important tool for transition has come under pressure

The EU ETS, EU's flagship carbon market since 2005, operates on a "cap-and-trade" principle. This means setting a limit on total emissions from sectors in scope, including power generation, energy-intensive industries (e.g., steel, cement), and intra-European aviation – covering about 40% of total EU emissions. Companies either buy or receive EU free allowances (EUAs) to emit carbon dioxide equivalents (CO_2e). The logic is that tightening caps and reduced EUA supply will make emission reducing measures more economical than emitting the CO_2e.



Source: EEA

That said, the Russian invasion of Ukraine and now closure of the Strait of Hormuz has led right-leaning politicians to push for weakening the system on a rationale of alleviating price increases and protecting competitiveness. Following the closure of Hormuz, Italy, Czechia and Slovakia were in end-February advocating for freezing the ETS to protect consumers and industry. While Czechia and Slovakia are more exposed to transition risk (see graph below), Italy under Meloni has aligned itself more closely with Trump's MAGA movement.



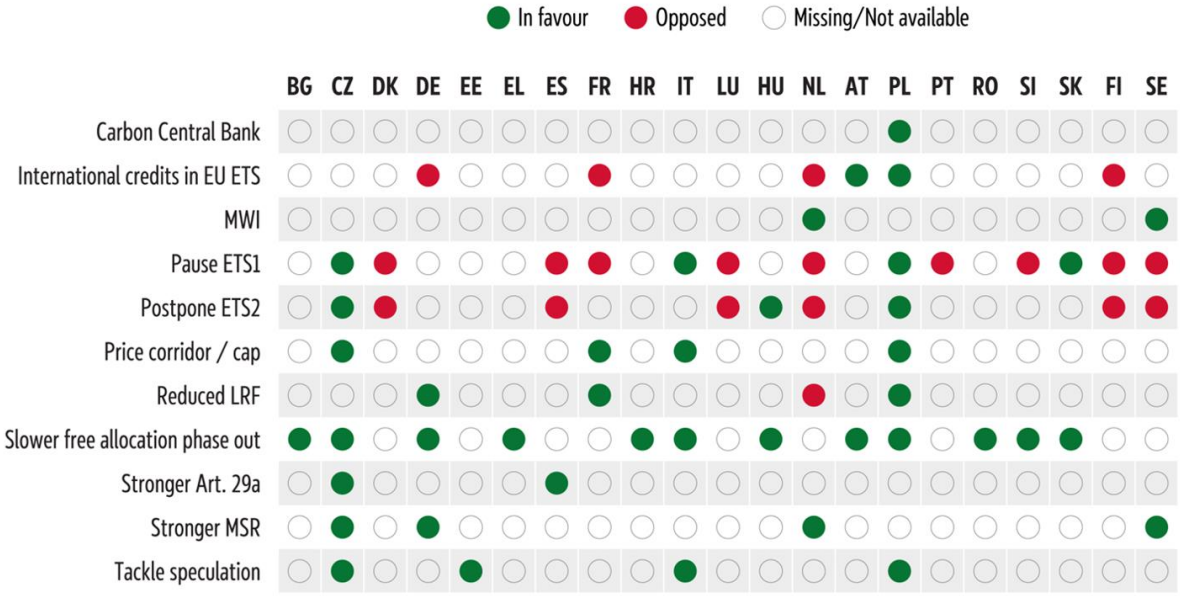
Source: Bruegel

A constellation of EU members responded by publishing a non-paper on March 12 rejecting the idea of an ETS suspension – with France, Germany and Spain also having pushed back against the proposition. Then, on March 20 at the European Summit, European Commission President Ursula Von Der Leyen said that the EU ETS "works" and that any measures to deal with the energy prices would have to be "temporary and tailored".

July ETS review a key test for Europe's transition momentum

While an ETS suspension appears off the table, there are many details that will be assessed in the review due in a bit more than two months that will give indications on ambition levels (see table below). We will below focus on the 1) Linear Reduction Factor (LRF) 2) Market Stability Reserve (MSR), and 3) free allowances.

EU Member State positions on EU ETS review (as of April 2026)

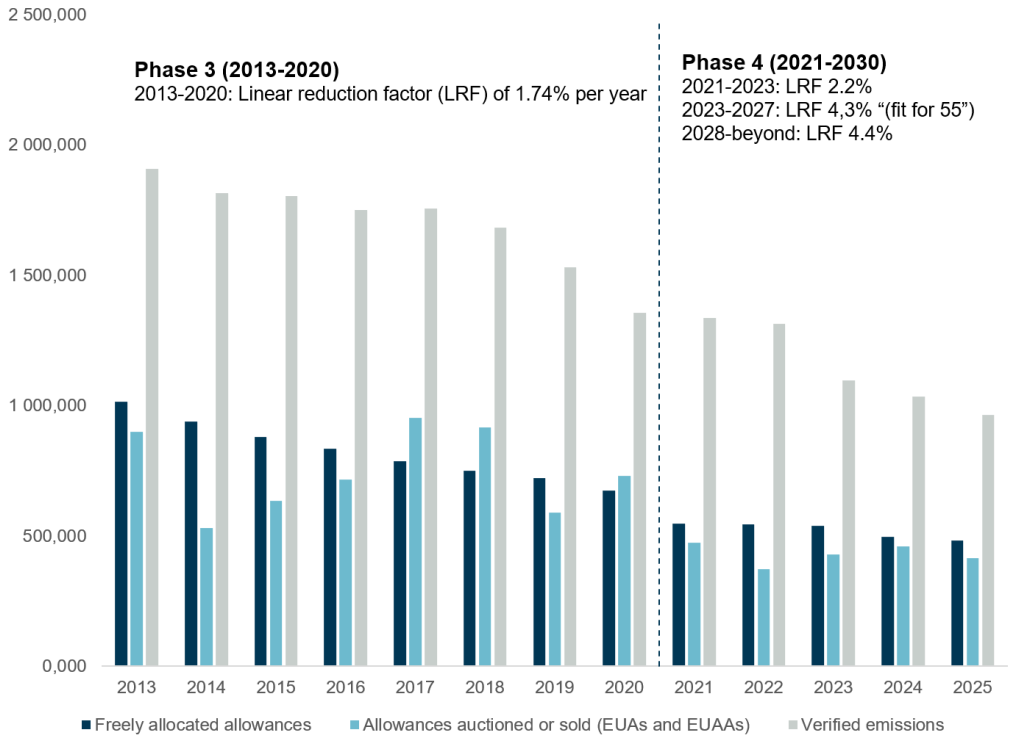


Source: European Parliamentary Research Service based on available information.

1. Updating ETS Linear Reduction Factor to reflect 2040 climate target

First, some context. The ETS has run in phases, where phase 1 ran from (2005-2007), phase 2 (2008-2012), Phase 3 (2013-2020) and Phase 4 (2021-2030). The phases typically are characterized by revisions from previous phases, and one key innovation in Phase 3 was the Linear Reduction Factor (LRF) introduced in 2013. The LRF reduces available EUAs annually at defined rates and started up against a 2008-2012 baseline. The LRF has increased several times to accelerate EU emission reductions (see graph below). Following the 2021 "Fit for 55", the LRF rate in Phase 4 nearly doubled from 2.2% per year to 4.3% per year from 2023. This reflects the EU climate target upgrade from 40% GHG emission reductions by 2030 compared to 1990 levels, to a 55% reduction. For ETS sectors this implied a reduction in emissions of 62% by 2030 compared to 2005.

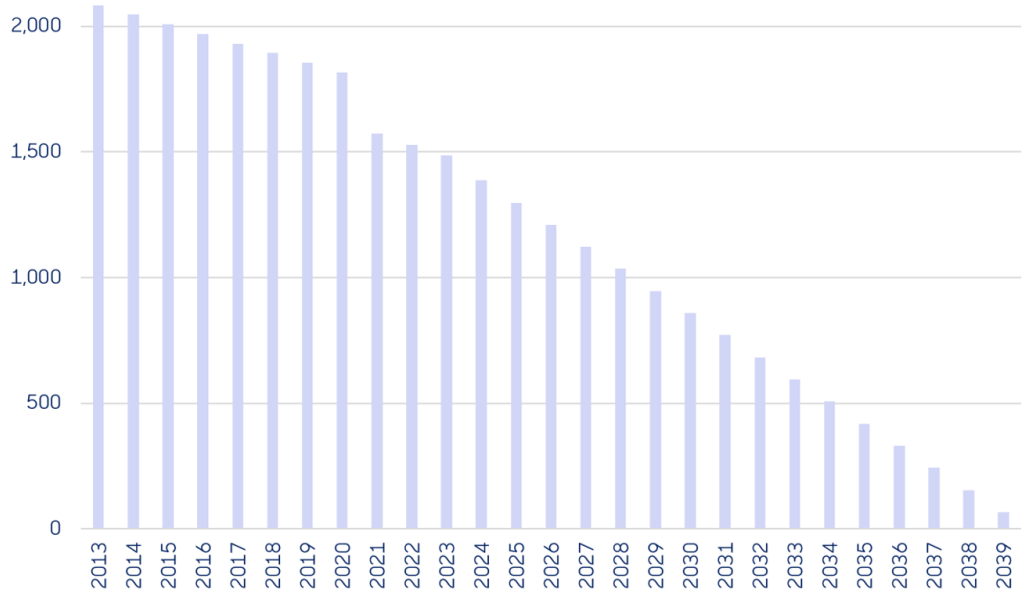
Verified ETS emissions versus auctioned/sold and free allowances, Million tons



**EUAA = Aviation allowance. Source: EEA*

Against this backdrop, a key focus of the EU ETS review will be to figure out how to appropriately integrate EU's new climate target of a 90% emission reduction by 2040 compared to 1990 levels. A key focus of such efforts will be to decide the LRF rate in an upcoming ETS Phase 5 (2031-2040). A key part of this will be to assess whether the sectors under the ETS can decarbonise fast enough to cope with a rapidly dwindling supply of EUAs.

EU ETS past and projected supply with 4,4% LRF, million allowances



**4.4% LRF from 2028 and beyond. Source: Homaio based on European Commission*

When the 2040 target was agreed, the European Commission stated that the trajectory of the ETS – meaning the LRF – would allow for a small amount of emissions post-2039. There have also been repeated rumors of some intending to propose a LRF of 3,4% from 2029 in the review - which would imply the end of allowances in 2042. While this would entail a weakening of original trajectories, it is a far cry from calls for suspending the ETS system altogether.
Depending on how the current energy crisis evolves, there may be calls for a further weakening of the LRF than what has to date been discussed. Should this happen, it would likely deal a blow to corporates that have taken decarbonization investment decisions on expectations of higher EUA prices due to a future tightening in allowance supply. To this end, more than 100 European companies and investors urged EU leaders in March to preserve a strong ETS, and that weakening it could damage industrial competitiveness and slow the transition to clean energy.
In other words, a weakened ETS would slow the European transition, punish climate frontrunners and reward laggards in a time when accelerating transition appears key to addressing Europe's fossil fuel import dependence. It would also make EU climate policy a source of significant political risk for investors. Hence a significant weakening of ETS allowance reduction trajectories seems unlikely, while a calibrated LRF weakening appears on the table.

2. Ensuring the Market Stability Reserve is a key buffer against volatility
Another key structural reform of the ETS Phase 3 that is now up for discussion is the Market Stability Reserve (MSR). Agreed in 2015 and operational since 1 January 2019, the MSR addresses the surplus of EU allowances compared to the "cap" by adjusting auction volumes based on the total number of allowances in circulation (TNAC). In Phase 4, since 2024 – the MSR rules are as follows:

- **Buffer MSR level:** The MSR withholds 24% of the TNAC when the surplus exceeds 1096 million.
- **Upper threshold:** If the surplus is below 1096 million and above 833 million (the upper threshold) the MSR absorbs the TNAC difference between 1096 and 833.
- **Lower threshold:** The MSR can release 100 million EUAs if TNAC falls below 400 million (the lower threshold).
- **Cancellations:** Since 2024, the MSR reserve can hold a maximum 400 million EUAs, and hence all allowances above this figure are invalidated.

Together with a higher linear reduction factor, the MSR has been key to tightening the ETS EUA market and supporting higher prices. The MSR ability to respond to supply imbalances therefore make it a key part of the discussion on how to respond to the current energy crisis.

EU ETS carbon permit price, EUR per EUA

Source: Trading Economics

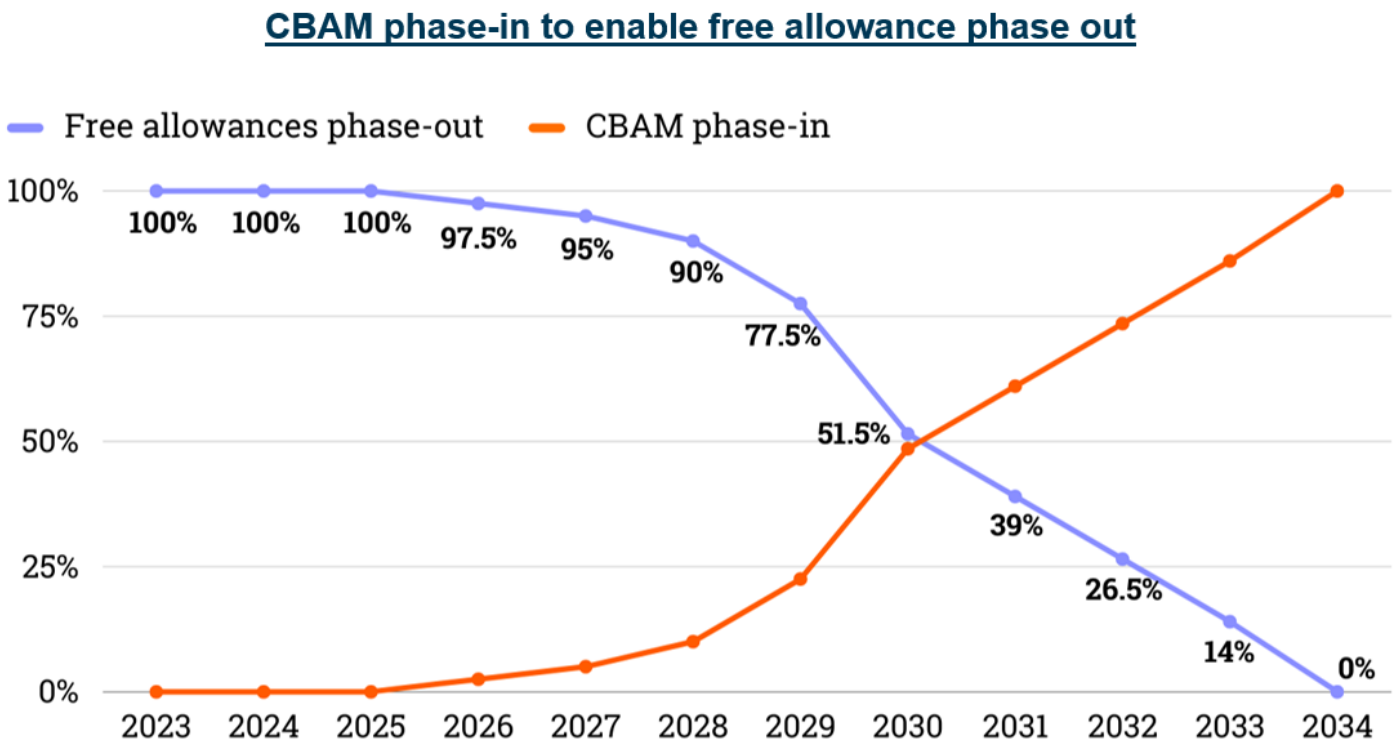
To this end, the European Commission announced a proposal on April 1 to change some of the rules governing the MSR. Specifically, the proposal suggests stopping the invalidation rule currently applying when the EUA reserve surpasses 400 million. The logic is that the EU will need a significant buffer to respond to market volatility. The proposal is separate to the ETS review, which will contain further "relevant adjustments to the MSR" according to the Commission statement.
Those pushing to weaken the ETS price significantly would want to use a larger reserve to reduce prices and perhaps even flood the market if given the opportunity. This would have the same adverse effects for sentiment as a gutted LRF. That said, the MSR amendment appears key to addressing future volatility as a declining supply of allowances are due to be auctioned at the end of ETS Phase 4 and eventually Phase 5. A larger MSR would reduce risks for a supply crunch and spiraling permit costs should ETS sectors be unable to reduce emissions fast enough. This is referred by some as problems stemming from the EU ETS "end-game" as available EUAs trend towards zero.

3. Free allowance phase-out rates up for discussion

The EU ETS grants some sectors installations free allowances to limit carbon leakage while preserving the carbon price signal. The logic is simple, certain sectors exposed to international competition would not be able to compete with those companies operating in jurisdictions with less or no carbon price. Free allocation uses benchmarks reflecting the best performers and historical activity, tightened over time. Operators emitting below their free allocation can bank or sell the surplus. The carbon leakage list, based on trade exposure and emission intensity, determines which sectors receive a higher share of the benchmark (up to full).
In the lead-up to the EU ETS review, Italy has been a proponent of scrapping the ETS benchmark revision altogether. Free allocation benchmarks are to be reassessed twice in Phase 4, to ensure they reflect technological development and that segments progressing faster than expected do not receive windfall profits. Scrapping the revision would likely reduce the pressure for certain industries to decarbonise or substantially reward frontrunners or sectors for which solutions are becoming

available. Instead, a more measured approach to softening the phase-out trajectory seems likely. The European Commission has pre-war in 2026 communicated that it is considering plans to slow the phase-out of free allowances post-2028 – with research from the European Parliamentary Research Service suggesting that there is support for this (see table above).

Finally, the free allowance discussion is intertwined with the complex phased introduction of the Carbon Border Adjustment Mechanism (CBAM) between 2026 and 2034, which imposes a carbon price on the border for products with carbon leakage risk. The aim of CBAM is to enable the phase-out of free allowances (see graph below). The CBAM initially focuses on cement, iron and steel (including certain downstream products), aluminium, fertilisers, electricity and hydrogen. Importers had to start surrendering CBAM credits (per ton CO2e) to cover parts of the embedded emissions of their imports from 2026.



Source: Table Briefing based on European Parliament data

However, there are concerns that the CBAM is unable to appropriately capture downstream products – which often is the way e.g., aluminium is exported to Europe. Hence, it was announced in late 2025 that the EU proposed to expand the CBAM to 180 downstream products to avoid circumvention. The inherent complexities in landing this correctly does pose risk for free allowance phase-out schedules. To this end, Article 27a, which is up for discussion in the review, would enable a temporary suspension of CBAM if a sector's inclusion cause "severe harm for the EU internal market". Again, this highlights the risk that political decisions to intervene in the market could inject uncertainty for companies and investors planning for a long-term tightening EUA supply and the phase-out of free allowances.

Sustainable products update

Europe Remains the Engine of Global Green Bond Supply

Despite broader scrutiny of ESG, green bonds continue to gain acceptance as a mainstream funding instrument. Global green bond issuance is up approximately 32% year-to-date, pointing to a resilient market despite continued macroeconomic volatility. Growth has been driven mainly by corporate issuers and sovereign, supranational and agency (SSA) borrowers, while issuance from financial institutions has remained broadly flat. SSA green bond issuance has reached record levels, reflecting the continued role of public sector funding in financing climate-related investment.

Momentum has been led by the euro market, which continues to serve as the main engine of global green bond supply, supported by a well-established investor base.

Utilities Dominate EUR Corporate Green Bond Issuance and EU Green Bond Standard

Within the euro market, utilities dominate corporate green bond issuance, accounting for roughly half of total euro corporate volumes. This is consistent with the capital-intensive nature of the energy transition, driven by sustained investments in power generation, grid expansion and electrification. Refinancing of existing green bond maturities has also contributed to issuance volumes.

Utilities have also been among the leading adopters of the EU Green Bond Standard (EuGB). High EU Taxonomy alignment, scale and continued presence in the euro bond market have positioned the sector well to meet EuGB requirements. Recent regulatory clarification allowing the refinancing of eligible capital expenditure under the EuGB label has further expanded the pool of eligible green expenditures, particularly for issuers with long-dated investment programmes.

From an investor perspective, the EU Green Bond Standard has generally been well received, with many investors valuing the increased transparency, standardisation and credibility it brings. At the same time, investors broadly acknowledge that the standard can be demanding for issuers to implement. It is also recognised that EuGB issuance is currently concentrated in a limited number of sectors—primarily energy and transmission, transport and buildings—while the traditional ICMA-aligned green bond format continues to offer broader sector diversification.

In this context, the ongoing revision of the EU Taxonomy—following the close of the latest feedback round—could, if the intended simplification is achieved, further support reported alignment and help ease implementation of the EU Green Bond Standard.

Sustainability-Linked Bonds: A Market at a Crossroads

After expanding rapidly following their introduction, SLB issuance has slowed materially in recent years, particularly among euro-denominated corporate issuers. This development reflects increased investor scrutiny around target ambition, KPI design and the effectiveness of penalty mechanisms, alongside a broader shift towards use-of-proceeds formats with clearer regulatory alignment.

Against this backdrop, 2026 represents a pivotal year for the SLB market. By the end of 2025, approximately 40% of outstanding euro corporate SLBs (by volume) had reached their target observation dates, triggering disclosure on performance outcomes. Public disclosures to date indicate that 39 euro-denominated corporate

SLBs have announced performance outcomes, with around 26% missing at least one target and approximately 74% meeting their stated objectives.
This represents the first large-scale performance assessment of the SLB format, shifting attention from framework design to delivery and execution. As financial penalties begin to materialise and further bonds approach observation dates, issuer performance is likely to play a more prominent role in shaping investor confidence, pricing differentiation and future issuance decisions—marking a more mature and disciplined phase for the SLB market.

In brief:

- **Milieudefensie launches a new climate case against Shell.** Milieudefensie (Friends of the Earth Netherlands) has filed a second Climate Case against Shell, demanding that the company stop drilling for new oil and gas fields. The new case follows Shell's March 2025 announcement of plans to increase LNG production beyond 2030, as well as a court ruling acknowledging Shell's responsibility to reduce emissions. Milieudefensie is also demanding that Shell set interim targets to ensure emissions reductions between 2030 and 2050.

- **Norway joins Brazil to co-lead ambitious rainforest fund.** Norway has joined Brazil as co-chair of the Tropical Forest Forever Facility (TFFF), an innovative international fund aimed at preserving tropical rainforests. The fund, launched at COP30 in Brazil, seeks to secure long-term financing for rainforest protection and boasts an ambitious target of raising 125 billion USD.Norway's Minister of Climate and Environment, Andreas Bjelland Eriksen, highlighted the importance of safeguarding rainforests for both climate action and biodiversity. Norway has pledged up to 3 billion USD in loans, contingent on co-financing from other sources.

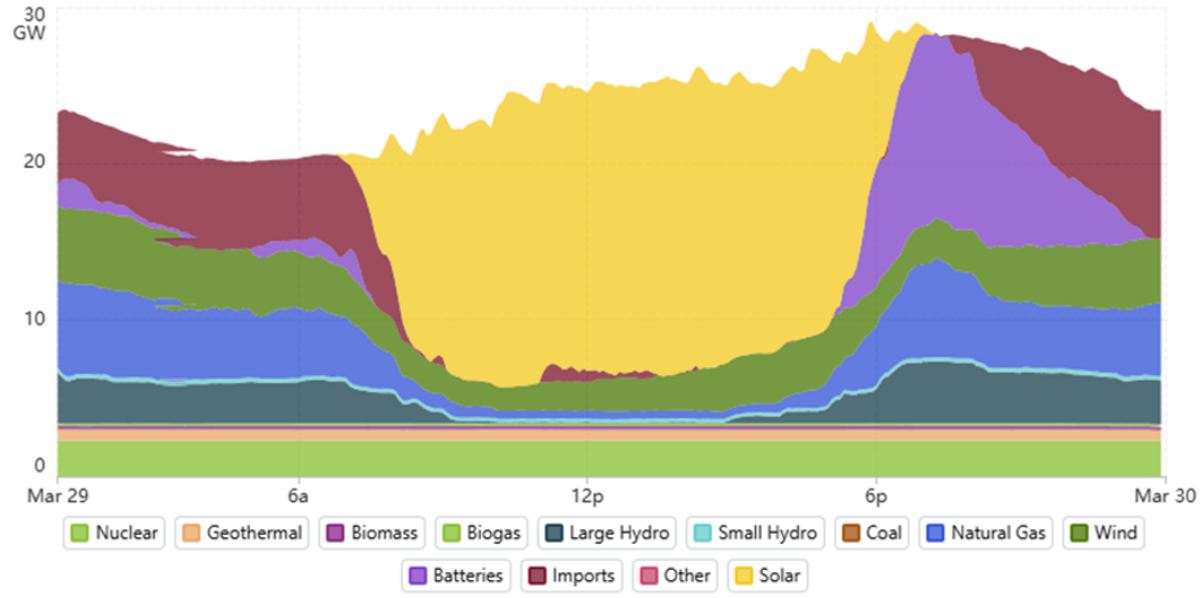
- **ISO Sets New Global Standard for Environmental Performance**. The International Organization for Standardization (ISO) has released an updated version, ISO 14001:2026, of its environmental management standard considered the world's most widely used and applied by more than 670,000 organizations globally. The update strengthens requirements on governance, climate alignment, resilience, and measurable environmental outcomes. ISO 14001:2026 elevates leadership accountability, placing greater emphasis on how environmental risks and opportunities are managed at board and executive level. Environmental considerations are expected to be integrated

across value chains, with clearer links to climate adaptation, biodiversity, resource efficiency, and operational resilience.

- **Grid batteries in California are showing the way.** The world's fourth-largest economy, California, set an impressive new record in late March when grid-scale batteries supplied 44% of evening electricity demand during the early evening peak. At 7:00 pm local time on Sunday, March 29, grid batteries delivered peak output of more than 12,000 megawatts (see graph of the month below). During the daytime, batteries were heavily charged by absorbing excess solar generation, and discharge was concentrated in the early evening hours. However, batteries continued to supply a significant share of electricity throughout the evening, exceeding 20% of total demand for almost four hours. As in many other power systems with high levels of battery storage, deployment in California has been rapid over the past few years scaling from 500 megawatts in 2020 to over 16,000 in late 2025. A similar development can be seen in South Australia. With a target of 100% net renewables by the end of 2027, the region reached a notable milestone in November 2025 when grid batteries supplied around 40% of demand during peak periods.

Graph of the month:

California Independent System Operator (CAISO) fuel mix, 29 March



Source: GridStatus.io

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