

FIT FOR 55 - EU STEPS IN TO AVOID CARBON LEAKAGE WITH NEW REGIME

22 July 2021 | Insight
Legal Briefings

We assess revised emissions trading and anti-carbon leaking measures.

On 14 July 2021, the European Commission (the **Commission**) published its proposed regulation which would establish a carbon border adjustment mechanism (**EU CBAM**) (the **Regulation**), and is intended to come into effect, subject to transitional provisions, from 1 January 2023.

The Regulation would require importers of certain goods to purchase a number of electronic certificates, each certificate corresponding to one tonne of embedded emissions in certain goods (**CBAM certificate**), in order to cover the total embedded emissions in imported goods. Although the obligation to purchase CBAM certificates and account for embedded emissions rests on importers, it is likely that the EU CBAM will have important impacts on international producers.

THE ROLE OF A CBAM

As explained in our previous blog post [here](#), a CBAM can be used to protect against the risk of carbon leakage and preserve the competitiveness of domestic operators. Carbon leakage occurs if, due to costs incurred in relation to climate policies, businesses in certain sectors transfer an underlying economic activity and its associated emissions to a different country with less onerous climate policies. This can lead to an increase in emissions globally.

A CBAM may prevent carbon leakage as all goods within its scope, whether produced domestically or internationally, would be subject to carbon costs, thereby discouraging businesses from relocating their operations elsewhere, or importing goods from countries with less ambitious climate policies.

GOODS WITHIN SCOPE OF THE EU CBAM

The goods within the scope of the EU CBAM include cement, electricity, fertilisers, iron, steel and aluminium. With the exception of electricity, the production or manufacture of these goods all figure on the 'Carbon Leakage List' under the EU Emissions Trading System (**EU ETS**), as sectors and subsectors deemed at risk of carbon leakage for the period 2021 to 2030. However, not all sectors and subsectors on the Carbon Leakage List are within scope of the EU CBAM.

THE MECHANICS OF THE EU CBAM

The EU CBAM applies when the above goods are imported into the Union's customs territory from a third country. It would not apply to goods originating in countries and territories listed in Annex II of the Regulation, which include Iceland, Liechtenstein, Norway and Switzerland. A process is proposed for other countries to be exempted.

Annual declaration

Before any goods within the scope of the EU CBAM are imported, an importer must apply to the competent authority in the Member State where it is established for authorisation to import those goods into the customs territory of the Union. Each Member State is required to designate a competent authority to administer the EU CBAM.

Once authorised, an importer must submit to the competent authority a declaration by 31 May each year (**CBAM declaration**) for the calendar year preceding the declaration. A CBAM declaration must include certain information relating to the embedded emissions in imported goods, and the total number of CBAM certificates which will be surrendered.

During the transition period, the EU CBAM shall apply as a reporting obligation: importers must report the information above, as well as the carbon price due in a country of origin for the embedded emissions in imported goods.

CBAM certificates

By 31 May each year, each importer must surrender to the competent authority a number of CBAM certificates that corresponds to the embedded emissions in its CBAM declaration.

Embedded emissions are defined as direct emissions released during the production of the goods, i.e. emissions from the production processes of goods over which the producer has direct control.

The Regulation provides that the amount of embedded emissions will be based on the actual direct emissions of goods. If this cannot be determined, a default value will be used. The Commission shall adopt implementing acts to establish detailed rules regarding the methods for calculating the actual embedded emissions of imported goods. Operators and installations in third countries will have the option of registering in a central database: once the embedded emissions of their goods have been verified, importers may use these embedded emissions figures in their CBAM certificate calculations.

The default value will be set in accordance with the average emission intensity of each exporting country for each of the goods within the scope of the EU CBAM (other than electricity), increased by a mark-up. If reliable data is not available, the default values will be based on the average emission intensity of the 10% worst performing EU installations for that type of goods.

Importers will be able to purchase CBAM certificates from the competent authority in the Member State in which they are registered. CBAM certificates will be sold at the price calculated by the Commission, which shall be the average price of the closing price of EU ETS allowances on the common auction platform for each calendar week. Each CBAM certificate will be valid for two years, which will enable importers to take advantage of fluctuations in the price of EU ETS allowances.

Reduction to reflect carbon price paid in a country of origin

In its CBAM declaration, an importer may claim a reduction in the number of CBAM certificates to be surrendered, in order to take into account a carbon price paid in the country of origin. The Commission is empowered to adopt implementing acts to establish the methodology for calculating the appropriate reduction, the conversion of a carbon price paid and the certification process for these.

The number of CBAM certificates to be surrendered may also be reduced in light of EU ETS allowances which would be freely allocated to EU producers of the same products (see below).

INTERACTION WITH THE EU ETS

The EU ETS will continue to apply to the goods within its scope produced in the EU, whilst the EU CBAM will create a carbon price for goods (within the scope the Regulation) imported into the EU.

Although there are differences in scope between the EU ETS and the EU CBAM, the Regulation demonstrates that the two carbon pricing systems will not operate in separate vacuums. In addition to the link to the EU ETS allowance price (see above), the Regulation also provides that the number of CBAM certificates to be surrendered will be adjusted, to reflect the extent to which installations producing goods within the scope of the EU CBAM are entitled to free allocation of allowances under the EU ETS. The methodology of this calculation will be adopted by the Commission in an implementing act.

Further, in the event of non-compliance with the Regulation, i.e. if an authorised importer fails to surrender sufficient CBAM certificates by 31 May each year, the authorised importer shall be liable to a penalty identical to the excess emissions penalty under the EU ETS. However, payment of such a penalty would not relieve an authorised importer from the obligation to surrender the outstanding number of CBAM certificates in a particular year.

IMPACT ON THE UK

As the UK is now a third country under the Regulation, EU importers would be liable to comply with the EU CBAM when importing certain goods (see above) from the UK. The Regulation empowers the Commission to adopt implementing acts to establish the methodology for calculating the reduction in the number of CBAM certificates to be surrendered in light of carbon prices paid in a third country. The Regulation also includes a transitional period during which such acts may be adopted.

However, until the reduction methodology is established, EU importers of UK-produced goods may experience a degree of uncertainty, with goods subject to the UK ETS upon production in the UK, and also to the EU CBAM upon import to the EU.

COMMENT

Ahead of the publication of the Regulation, a number of commentators raised concerns that an EU CBAM could be anti-competitive and protectionist in nature. The Commission stresses that it has taken such concerns into consideration in the design of the EU CBAM, as the final version of the Regulation contains a number of features which it claims addresses such concerns:

- The price of CBAM certificates is linked to the EU ETS price. As the goods within the scope of the EU CBAM (when imported from third countries) are within the scope of the EU ETS when produced in the EU, all such goods in the EU will be subject to a carbon price, set at a similar level. This would in theory prevent carbon leakage (see above), as importers would not be able to obtain cheaper goods by importing from a country with less onerous climate policies.
- The Regulation also provides for a reduction in the number of CBAM certificates to be surrendered in the event that domestic EU producers of such goods would be entitled to free allowances. This feature aims to ensure that EU producers and EU importers compete on a 'level playing field': if an EU producer would have been entitled to freely allocated allowances for producing the imported goods, the importer will be required to surrender fewer CBAM certificates (thereby reducing the carbon price paid by the importer). Because of the different bases of calculation of free allowances and CBAM certificates, it may be complicated to implement this mechanism in a way that is non-discriminatory in all cases.

In spite of the Commission's assertions that the effects of the EU CBAM will be EU-focussed, concerns have been raised that it will have a significant impact on producers in third countries. The price of imported goods within the scope of the EU CBAM is likely to increase, which may reduce the price competitiveness of these products within the EU single market. Alternatively, if such a price increase were not passed on to consumers, the value of the imported goods may decrease, as EU importers may try to off-set the new carbon cost of these products against their initial purchase price.

Although the primary aim of the EU CBAM is to prevent the risk of carbon leakage, the Commission has suggested that it may encourage the use of more greenhouse gas emissions-efficient technologies by producers from third countries. It remains to be seen whether this will be the case, and whether the EU CBAM will trigger other countries to adopt more ambitious domestic climate policies.

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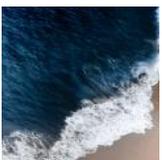


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If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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