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EU Climate Action: Imminent Introduction of the Carbon Border Adjustment Mechanism

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On December 13, 2022, negotiators of the European Council and the European Parliament reached a provisional agreement on the Carbon Border Adjustment Mechanism ("CBAM"), a carbon tax impacting certain goods (or processed products from those goods) imported into the customs territory of the EU from outside it. On April 18, 2023, the Parliament formally approved the deal in a 413–167 vote (with 57 abstentions), and the Council gave its formal approval one week later. The legislation will shortly be published in the EU Official Journal and enter into force.

Part of the EU's "Fit For 55" package, CBAM's aim is to complement the world's largest emissions trading system, the EU Emissions Trading System ("EU ETS"), by preventing the risk of carbon leakage to jurisdictions with a lower or non-existent carbon price, and to support the goals of the Paris Agreement. The CBAM intends to put a fair price on the carbon emitted during the production of carbon-intensive goods entering the EU, and to encourage cleaner industrial production in non-EU countries. Its staged application aligns with the intended phase-out of the allocation of free allowances under the EU ETS in support of the decarbonization of EU industry.

In this *Alert*, we provide an overview of the CBAM, which has significant implications for private fund managers with portfolio companies in the regulated sectors that do business in the EU, as well as for global companies with a presence in the regulated sectors.

Overview of Carbon Border Adjustment Mechanism

As noted above, CBAM is part of the EU's Fit for 55 package, which aims to provide a comprehensive framework for reaching the EU's climate objectives — including a 55% greenhouse gas ("GHG") emissions reduction from 1990 levels by 2030[1] — by revising and updating existing EU legislation with new initiatives. The package covers reforms across several policy areas such as energy, environment, transport and financial affairs.

CBAM addresses the risk of carbon leakage, which occurs when businesses in carbon-intensive sectors transfer production to countries with a lower or non-existent carbon price, or consumers substitute higher-carbon imports. To date, the EU ETS (which works on a "cap-and-trade" principle and covers around 40% of total EU emissions) has allocated free carbon allowances to allow European manufacturers in carbon-intensive industries to compete with manufacturers not subject to a carbon price; however, there has been concern among policymakers that these free allowances weaken the price signal and thus negatively impact the incentives for further abatement of emissions.

CBAM is being introduced at the same time as EU ETS reforms phasing out the current system of free allowance allocation, in order to ensure equivalent, robust carbon pricing for imports and domestic products.

CBAM targets goods that are imported into the EU's customs territory and have a high risk of carbon leakage: steel, iron, cement, organic basic chemicals, aluminum, fertilizers and electricity generation.[2] It will initially apply to direct emissions of CO_2, N_2O and PFCs from the production of goods up to the time of import into the customs territory of the EU. It excludes goods imported from countries that operate an emissions trading system linked with the EU ETS, and credits carbon payments made in the country of origin for embedded carbon emissions.

Scheduled to apply from October 1, 2023 (with a transition period through 2025 where only reporting will be required), companies in the target sectors that import into the EU will be required to (i) submit an annual declaration of the total verified embedded GHG emissions in the goods imported into the customs territory of the EU by 31 May of each year, for the preceding year, and (ii) in due course, surrender a number of CBAM certificates by 31 December of the year following the CBAM declaration, corresponding to those declared emissions. Penalties will apply where a CBAM declarant fails to surrender CBAM certificates corresponding to the volume of embedded GHG emissions imported.

For the sale and purchase of CBAM certificates, a common central platform will be established. Pricing of CBAM certificates will reasonably reflect the average price of EU ETS allowances released into the market on a weekly basis.

Key Considerations for Companies and Portfolio Managers

In parallel with the provisional agreement on CBAM, the Council and Parliament also agreed in December to set an ambitious target of emissions reductions of 62% (compared with 2005) in the sectors covered by the EU ETS. Further, they agreed to increase the annual reduction rate of the cap by 4.3% per year from 2024 to 2027 and 4.4% per year from 2028 to 2030. A faster reduction of the cap means there will be fewer allowances on the market, with the cap to get a rebase of 70 million allowances in 2024 and 50 million allowances in 2026, following a one-off reduction of 117 million allowances. The EU ETS is also being extended to cover maritime transport,[3] and a new ETS is envisaged to cover buildings, road transport and fuel for additional sectors. At the same time as these changes, in February 2023, the price of allowances in the EU ETS hit €100 per tonne for the first time, driven by market forces and regulatory expectations. This price is considered to be an important threshold at which investment in decarbonization technologies may become more optimal than purchasing allowances.

Altogether, these legislative and market changes mean companies in the regulated sectors doing business in the EU will face significant new incentives to decarbonize. Companies subject to the EU ETS or that import products within the scope of CBAM into the EU should expect to be subject to increasing scrutiny and disclosure requirements, and to experience a gradual increase in costs that may impact participants along the value chain. These costs include not only the cost of allowances or CBAM certificates, but also compliance costs associated with tracking and reporting embedded carbon emissions. Similarly, managers of private funds with portfolio companies affected by the legislation could face administrative costs associated with helping their portfolios make adjustments to comply with the regulatory requirements. CBAM may also encourage portfolio managers to access new markets and expand their portfolios to focus on low-carbon solutions — such as clean technology and natural capital strategies — as well as incentivize energy transition plays.

1. Other stated climate objectives are: ensure a just and socially fair transition; maintain and strengthen innovation and competitiveness of EU industry while ensuring a level playing field vis-à-vis third country economic operators; and underpin the EU's position as leading the way in the global fight against climate change. ↩

2. CBAM will also be extended to hydrogen, certain indirect emissions, as well as some downstream products such as screws and bolts and similar articles of iron or steel. ↩

3. This extension is to be introduced gradually between 2024 and 2026. ↩

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