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Final regulations published for new EU Carbon Border Adjustment Mechanism (CBAM) and EU Emission Trading System revisions; CBAM transition period begins 1 October 2023

- *On 16 May 2023, regulations for revising the European Union Emission Trading System (EU ETS) and the new EU Carbon Border Adjustment Mechanism (CBAM) were published in the Official Journal of the European Union.*
- *A transitional period will apply for EU CBAM from 1 October 2023 to 31 December 2025, with solely quarterly reporting obligations; from 2026 onward, purchasing CBAM certificates will be required.*
- *The EU ETS will be extended in the aviation and maritime sectors; new ETS II will cover fuels for transportation and heating.*
- *Free allowances under the EU ETS will be phased out starting in 2026.*
- *Businesses (EU and non-EU) are advised to assess the potential impact and prepare for new CBAM reporting obligations starting later this year.*

Executive summary

On 16 May 2023, a significant milestone was passed as legal regulations for European Union Emission Trading System (EU ETS) reform and the new EU Carbon Border Adjustment Mechanism (CBAM) were published in the *Official Journal of the EU*.

The EU's "Fit for 55" legislative package, which was initially announced in July 2021 and includes the new CBAM and ETS reform, is viewed as a key enabler for helping Europe reduce emissions at least 55% by 2030 (from 1990 levels). These targets are set out in the European Climate Law and are part of the wider European Green Deal strategy to achieve climate neutrality by 2050.

A transitional period for CBAM will begin 1 October 2023 and extend through 2025, during which time quarterly emissions reporting will be required. Affected businesses will need to get ready to comply with new compliance and reporting requirements starting later this year and begin to assess the medium- to long-term process and cost implications.

Key principles of CBAM

The EU CBAM is a climate measure that aims to address the risk of carbon leakage by ensuring equivalent carbon pricing for imports and domestic (EU) production that is subject to carbon costs under the EU ETS. While the EU ETS applies to installations based in the EU and to certain production processes and activities (and will be extended further, as detailed below), CBAM will apply to certain goods imported into the EU.

Scope of goods covered

CBAM will cover the following product categories:
- Kaolin and other kaolinic clays, calcined
- Cement, aluminous cement, cement clinkers, etc.
- Fertilizers (e.g., ammonia, nitric acid, sulphonitric acids)
- Agglomerated iron ores and concentrates
- Comprehensive coverage of iron and steel products (except some ferro-alloys, scrap etc.)
- The iron and steel products include downstream products, such as screws, bolts, nuts, coach screws, screw hooks, rivets, cotters, cotter pins, washers (including spring washers) and similar articles
- Aluminum structures and parts of structures
- Certain aluminum reservoirs, tanks, vats, containers
- Stranded wire, cables, plaited bands and the like, made of aluminum, not electrically insulated
- Other articles of aluminum
- Hydrogen
- Electrical energy

This product list has significantly increased compared to initial draft versions of the regulation; for example, downstream products are now included, not just raw and semi-finished materials. Therefore, the list will apply to a larger number of businesses.

Political discussions seem to favor extending CBAM further by 2030, to cover all product categories that are subject to the EU ETS if these products were manufactured in the EU. This would include polymers, diverse chemicals, mineral oil products, paper and pulp, among other categories.

Transition period: 1 October 2023 to 31 December 2025

Between 1 October 2023 and 31 December 2025, transitional provisions will apply. Quarterly emissions reporting will be required and purchasing CBAM certificates will be optional. Importers (customs declarants, indirect representatives) will be required to quarterly report embedded emissions in goods imported during that quarter of the calendar year, detailing direct and indirect emissions as well as any carbon price effectively paid in a third country.

Notably, from 31 December 2024, importers must have "authorized CBAM declarant" status to qualify for the import of in-scope goods.

How it will work

Under new CBAM rules, importers are required to report total verified greenhouse gas (GHG) emissions embedded in goods imported in a given calendar year. Following the transitional period (at the end of 2025), the financial impact of CBAM will gradually increase, with a progressive phase-in of CBAM costs until 2034. Carbon cost paid at origin can be deducted from the payable CBAM charges (provided that evidence of the cost can be made available).

Payment of CBAM charges will be facilitated through the purchase and surrender of CBAM certificates, which will be priced at the weekly averages of EU ETS allowances auctions.

During the calendar year, the importer must ensure that the number of CBAM certificates in its CBAM registry account at the end of each quarter corresponds to at least 80% of the embedded emissions in imported products since the beginning of the calendar year. The importer must surrender CBAM certificates in the exact number corresponding to emissions embedded in goods imported in the calendar year, in addition to submitting an annual CBAM declaration.

Definition of embedded emissions

CBAM charges correspond to embedded emissions in the named product categories, and the definition of embedded emissions to be declared has been extended to indirect emissions. The declaration of emissions can be made based on actual emissions, which need to be determined based on a schema provided by the EU regulators, although the details are not yet finalized. Implementing legal acts containing additional details are likely to be published in Summer 2023.

If actual emissions are declared, they must be accredited by independent verifiers. If no actual emissions are available, standard "default" values will be used that reflect average emissions for a certain product manufactured in a specific country or region. If no reliable data to determine these standard values is available, the EU Commission will determine default values based on the worst-performing EU installations. Further guidance is expected in the implementing acts in Summer 2023.

Exemptions and extended circumvention practices

CBAM will not apply to goods of nonpreferential origin in Switzerland, Liechtenstein, Iceland and Norway. There are only a small number of exemptions, including for low-value consignments up to €150 and certain military imports.

Examples of circumvention practices have been slightly extended in what is now an open catalogue of practices that may consist of, but are not limited to:

- Slight modification of goods to change Combined Nomenclature classification
- Artificial split of shipments to benefit from CBAM exceptions described above

Key changes to the EU ETS

One significant change to the current system is the phase-out of free allowances. Effectively, from 2026 to 2034, the free allowances granted to EU manufacturers will fade on a progressive curve, consequently increasing the cost of manufacturing for businesses if processes remain the same.

The following phase-out rates for free allowances will apply:

Year	2026	2027	2028	2029	2030	2031	2032	2033	2034
Rate	2.5%	5%	10%	22.5%	48.5%	61%	73.5%	86%	100%

Furthermore, revisions of EU ETS will include the following changes:

- Increase the overall goal for emissions reductions: 62% reduction by 2030 (compared to 2005 levels)
- Increase the speed of annual reduction rate of the cap: 4.3% per year from 2024 to 2027, and 4.4% from 2028 to 2030
- Reduce the EU-wide quantity of allowances of 90 Mt CO_2 equivalents in 2024 and 27 Mt in 2026
- Reinforce the mechanism on excessive price fluctuations, including providing for an automatic release of allowances from the Market Stability Reserve (MSR) to the market; 24% of all EU ETS allowances will be placed in the MSR to address possible imbalances between the supply of and demand for allowances in the market
- Reinforce conditionality requirements for installations benefiting from free allowances, notably energy audits and, in some cases, climate neutrality plans
- Remove derogation for installations for electricity generation, instead used for Modernization Fund to support decarbonization of energy sector
- Extend application of the EU ETS in the aviation sector:
    - EU ETS will apply for intra-European flights (including departing flights to the United Kingdom and Switzerland), while CORSIA (Carbon Offsetting and Reduction Scheme for International Aviation) will apply to extra-European flights to and from third countries participating in CORSIA from 2022 to 2027

    - When global aviation emissions under CORSIA offsetting reach levels above 85% of 2019 levels, European airlines will have to offset their proportionate share with corresponding carbon credits, invested in emissions reductions in countries participating in CORSIA offsetting
    - Free allocations of allowances to the aviation sector will be phased out by 2026; the gradual mechanism plans a decrease of 25% in free allocations for 2024 and 50% for 2025
- Reserve, from 1 January 2024 through 31 December 2030, 20 million allowances to be allocated to cover part of the remaining price differential between fossil kerosene and the eligible aviation fuels for individual aircraft operators
- Extend the scope of the EU ETS to maritime transport from 2024:
    - Gradual phase-in: 40% of verified emissions from 2024, extending to 70% for 2025 and 100% for 2026
    - Most large vessels will be included from the start in EU ETS, with other vessels included in "MRV regulation" (monitoring, reporting and verification of CO2 emissions) and included at a later stage in EU ETS
    - Agreement takes into account geographic specificities
    - Non-CO2 emissions (methane and nitrous oxide) will be included in the MRV regulation from 2024 and EU ETS from 2026
- Analyze, by 2026, the feasibility of including municipal waste incineration installations in the EU ETS from 2028
- Implement a carbon market (EU ETS II) to cover buildings and road transport by 2027 (or 2028 depending on market conditions):
    - Applies to distributors supplying fuels to heat buildings, conducting road transport and certain other sectors
    - Gradual increasing of linear reduction rate: 5.10% from 2024 and 5.38 from 2028
    - Some "frontloading" anticipated in the first year
    - Possibility for delay by one year in the case of carbon prices per ton exceeding €90
    - Anticipated prices will be capped at €45 per ton until at least 2030
    - Temporary exemption possible if suppliers are subject to a carbon tax at a national level equal or higher than auction price for allowances
    - Simplified requirements for smaller suppliers

It is important to note there will be no export rebates or refunds of carbon payments. All revenues generated by the carbon market will be spent on climate and energy-related projects.

In addition, a new EU Social Climate Fund will be set up in 2026:
- Designed to support vulnerable households, micro-enterprises and transport users who are particularly affected by energy and transport poverty, to ensure a fair and socially inclusive climate transition
- Funded from auctioning ETS II allowances up to an amount of €65 billion, with an additional 25% covered by national resources
- Estimated total of €86.7 billion

Implications for businesses

CBAM and the reform of the EU ETS will affect businesses both in the EU and across the globe, from an operational perspective and in terms of strategic decision-making. Impacts may be either direct or indirect. A holistic approach across the value chain and supply chain is recommended.

EU-based operators subject to EU ETS must plan for increasing carbon costs if usage of conventional fuels is continued. Consequently, increased costs may affect competition on the EU and global market for emission-heavy businesses. With the new EU ETS II, the price of conventional fuels will further increase and may catalyze the need for transformation in this sector. It is worth noting the EU and the EU Member States nationally provide large, diverse programs of grants and incentives to support businesses in the transition. Additional revenues from the carbon market will bring further funding opportunities as part of the EU Innovation Fund, especially for businesses investing in innovative low-carbon technologies.

Immediate steps to take

With the transition phase for CBAM beginning on 1 October 2023, preparing for the new quarterly reporting obligations will require immediate action. Importantly, EU operators and non-EU manufacturers and traders alike will need to consider CBAM requirements.

Steps include:
- Assigning internal responsibility for management of the regime, as a cross-functional response is essential
- Identifying CBAM-covered EU imports
- Preparing for transitional-period reporting requirements (e.g., conducting a data gap assessment in terms of data required on embedded emissions and carbon price at the location of manufacturing)

Furthermore, from a strategic point of view, businesses should assess the potential financial impact of CBAM and EU ETS based on the current supply chain and take appropriate mitigation actions where possible. Other anticipated changes in the energy and electricity tax areas (e.g., revisions to the Energy Taxation Directive) should also be taken into consideration.

Activities could involve rethinking supply chain structures, sourcing strategies, merger and acquisition activity, production planning, and investment planning to achieve technical improvements to reduce embedded emissions in imported products.

It will be important for businesses to monitor developments, especially as the implementing acts are expected in Summer 2023.

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