

Alert | Energy & Natural Resources



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EU Carbon Border Adjustment Mechanism Proposal and Its Relationship to the European Emission Trading Scheme

A new carbon policy under consideration by the European Union has implications for the global import/export market and would add significant compliance costs for certain industries. The Carbon Border Adjustment Mechanism (CBAM) is a carbon-pricing system for imports into the European Union.¹ It is aimed at adjusting the price of certain imported products to the amount of CO₂ emissions incorporated in them, in order to equalize the cost of carbon between EU products and these imports.

The CBAM, which is proposed to be applicable as of January 1, 2023, would initially only cover products from the following sectors:

- (i) the cement,
- (ii) iron and steel,
- (iii) aluminum,
- (iv) fertilizers, and
- (v) electricity industries.

¹ See Oct. 15 GT Alert, “EU Proposal for the Carbon Border Adjustment Mechanism,” for additional details on the proposal.

If implemented and applicable starting January 1, 2023, EU importers would have to begin reporting emissions embedded in these products on that date. In addition, EU importers would start paying a financial adjustment, as described below, as of January 1, 2026.

The measure is designed to reduce the risk that European companies move their carbon emission-producing activities outside the EU in order to take advantage of lower environmental standards (so-called carbon leakage) or that European products suffer competition from foreign production subject to lower carbon compliance costs.

In short, the mechanism requires that importers purchase specific emission-related certificates for a price equal to that which they would have paid if the goods had been produced within the EU. If, however, the importer can prove that a carbon price was already paid in the country of production, the corresponding cost can be deducted.

The countries likely to be most impacted by CBAM, in order, are: Russia, Turkey, China, Ukraine, India, the United Arab Emirates, Serbia, Mozambique, Egypt, the United States, the United Kingdom, and South Korea.

The United Kingdom and South Korea may be (almost) exempted given their own emission trading systems and generally higher CO₂ costs. These countries do, however, import a significant amount of goods into the EU that would be covered by the CBAM, so there could be exposure to significant compliance obligations.

CBAM and ETS

The relationship between the CBAM and the European Emission Trading Scheme (ETS) would be complex. The CBAM is proposed to be complementary to the ETS. In a nutshell, the ETS sets a cap on the total amount of certain greenhouse gases that can be emitted by industrial facilities in the sectors covered by the ETS. The cap is reduced over time so that total emissions decrease. Industries buy or receive emission allowances and must hold enough allowances to fully cover their emissions, otherwise incurring heavy fines. Therefore, the allowances have an economic value and can be traded by companies as financial instruments, allowing “virtuous” companies to sell their excess allowances and others to buy allowances if needed, thus encouraging investment in innovative technologies with low environmental impact. The allowances, in principle, are purchased through competitive auctions. However, some sectors, to a greater or lesser extent, receive part of their allowances free of charge to avoid an excessive competitive disadvantage with respect to non-EU companies. The number of free allowances is progressively reduced over the years.

Under the proposal, the price of CBAM certificates potentially would be measured based on the price of ETS certificates calculated per the weekly average auction price of ETS allowances expressed in EUR/ton of CO₂ emitted. In general, CBAM certificate prices would be applied only in specific sectors, gradually and in direct proportion to the reduction of free allowances allocated under the ETS. In other words, until free ETS allowances are completely eliminated in 2035, the CBAM would apply only to the portion of emissions that do not benefit from free ETS allowances, to ensure a carbon level playing field between European companies and those of third countries exporting certain goods into the EU.

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