CADWALADER

Regulation: EU Reaches Agreement on Carbon Border Tax

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Regulation

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Environmental regulators and ministers from across the EU member states **provisionally approved** the introduction of the world's first major carbon border tax, the Carbon Border Adjustment Mechanism (CBAM), which will require foreign exporters to the EU to pay for the cost of their carbon emissions. Imports into the EU of iron, steel, cement, aluminum, fertilizer, electricity generation, hydrogen and certain iron and steel products will be subject to the tax. The costs of carbon emissions for purposes of the tax would be calculated based on the actual Scope 1 and Scope 2 emissions that occur in the production of goods—defined as "embedded emissions." If actual emissions cannot be verified, the embedded emissions will be determined by the "default value," which is "based on the average emission intensity of the 10 per cent worst performing EU installations for that type of goods."

It is anticipated that the European Council and European Parliament will formally approve the CBAM, which will then become EU law. The tax will phase in gradually, with exporters initially having to provide emissions data starting on October 1, 2023. Peter Liese, lead negotiator for the European parliament, stated that the CBAM was "the biggest climate law ever in Europe, and some say in the world."

As part of the same package, policymakers also agreed to raise the emission reduction targets in industries covered by the European Emissions Trading System (EETS) to 62% by 2030 from the existing target of 43%. The EETS facilitates a "polluter pays" model by allowing electricity producers and energy-consuming industries a fixed amount of free pollution credits per year but requiring them to purchase additional credits to cover any excess carbon emissions. Companies that do not use all of their free credits can sell them. The number of available credits decreases each year. The new plan requires these covered sectors to significantly increase emissions reductions, in part, by reducing the allocation of free credits and completely phasing them out by 2034. The EETS currently covers emissions in energy-intensive sectors including cement, aluminum, iron and steel. The CBAM applies only to emissions *not* covered by the free allowances of the EETS. Furthermore, the lawmakers agreed to establish a Social Climate Fund to assist vulnerable households, small businesses and transport users in managing the impact of carbon pricing on energy costs.

The anticipated enactment of the tax has engendered controversy. Some of the EU's major trading partners have stated that it will expose affected industries to unfair competition. The United States and South Africa have expressed concern that the CBAM will penalize their manufacturing industries in having to compete with cheap imports from companies unwilling to pay the EU's tax and that instead will seek to export to other markets instead. Adina Georgescu, energy and climate director at the metal industry trade body Eurometaux, expressed that lawmakers must "find a solution for keeping our exports competitive" and that "companies cannot afford further revenue loss and uncertainty on top of today's existential energy crisis threat."

Marian Jurečka, environment minister for the Czech Republic, which currently holds the rotating presidency of the EU, stated that the agreement "will allow us to meet climate objectives within the main sectors of the economy, while making sure the most vulnerable citizens and microenterprises are effectively supported in the climate transition."

Koen Coppenholle, CEO of Cembureau, an EU cement trade association, stated that "we are still waiting to see the final details of the agreement, but from our perspective a strong CBAM is important to create a global level playing field on carbon dioxide emissions and support our sector in its transition to carbon neutrality."

Taking the Temperature: The announcement of the carbon boarder tax is significant. Assuming it is implemented in its current form, which is still somewhat uncertain due to the ongoing debate over compliance with World Trade Organization (WTO) rules, there may well be push back from countries affected by the tariffs. As made clear by Dutch MEP Mohammed Chahim, the CBAM is seen by EU policymakers as "one of the only mechanisms we have to incentivize our trading partners to decarbonize their manufacturing industry." It seems likely that the tax will be implemented in one form or another to enable the EU to bring direct commercial pressure on trading partners to reduce their reliance on fossil fuels. As we suggested in our article on EU legislation relating to deforestation, affected industries and companies should take steps now—even if the full implementation date of the legislation is still some way off. Companies should consider the impact this will have both directly on their products and on their supply chain as the increased costs will likely be passed onto them. Furthermore, they may see a reduction in availability as some non-EU suppliers decide to sell their products in alternative markets to avoid the regulatory burden.