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## Carbon Border Adjustment Mechanisms – EU Regulation and UK Consultation

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On May 17, 2023, the EU Carbon Border Adjustment Mechanism or CBAM entered into force.<sup>1</sup> A core element of the EU's 'Fit for 55' package of climate proposals, the CBAM is the EU's flagship regulatory instrument for tackling 'carbon leakage' (the replacement of production of goods in the EU with more carbon-intensive production in third countries to avoid the costs of EU climate change policies). The purpose of the CBAM is to create a level playing field for carbon pricing between domestic and imported goods within the EU single market.

Separately, on March 30, 2023, the UK government published a consultation on "Addressing carbon leakage risk", soliciting views on a UK CBAM, mandatory product standards and additional demand-side policies.<sup>2</sup>

### EU CBAM

#### Introduction

The CBAM will require importers of certain goods into the EU to pay a carbon price on greenhouse gas emissions embedded into the production of those goods equivalent to the cost of covering those emissions within the EU's own carbon pricing system, the EU Emissions Trading System or ETS. If that amount has not been paid through carbon taxes or for emissions allowances outside the EU, it must be topped up by paying for CBAM certificates at prices equivalent to EU ETS certificates. Initially the CBAM will cover (broadly) electricity, hydrogen, fertilisers, cement, aluminium, iron and steel.<sup>3</sup>

The CBAM will impose reporting requirements on importers of relevant goods into the EU (or their customs representatives) which will cover: (i) total quantity of relevant goods imported; (ii) total embedded emissions;<sup>4</sup> and (iii) the number of CBAM certificates to be surrendered to pay for those emissions.<sup>5</sup> On June 13, the EU Commission published for feedback a draft implementing regulation setting out more detail on the information to be reported, penalties for failure to report, methodology for calculation of emissions and other matters for the transitional period.<sup>6</sup>

#### Key considerations

Companies and investors along the value chains of the relevant goods imported into the EU should take note of the following key aspects of the CBAM regulation:

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- **The CBAM will be phased in gradually from October 2023.** October 1, 2023 to December 31, 2025 will be a 'transitional period' for which importers or their representatives will need only to report information (on total goods, embedded emissions and the carbon price in the country of origin) on a quarterly basis. The CBAM is expected to become fully operational by January 1, 2026.
- **Goods within the scope of the CBAM may only be imported into the EU by a 'CBAM declarant'.** Once fully operational, only so-called 'CBAM declarants' – importers who have been granted that status by the relevant national authority and are registered on the EU-wide CBAM registry – will be permitted to import relevant goods into the EU customs union.<sup>7</sup> Applications for 'CBAM declarant' status will open from December 31, 2024.<sup>8</sup>
- **CBAM declarants will need to report the carbon emissions embedded in their imported goods.** By May 31 each year (starting in 2027 for the year ending December 31, 2026), CBAM declarants will have to report the information set out above and provide copies of supporting reports by accredited verifiers.<sup>9</sup>
- **The carbon price of imported goods will be topped up by payment for CBAM certificates.** CBAM certificates are electronic certificates corresponding to one tonne of CO<sub>2</sub> equivalent of embedded emissions in imported goods. CBAM declarants must purchase and then surrender CBAM certificates for the embedded emissions they report, after reductions to reflect (i) the carbon price already paid outside the EU and (ii) the extent to which equivalent EU goods benefit from free ETS allowances.<sup>10</sup> CBAM certificates will be sold by EU Member States through a common central platform.<sup>11</sup> Although CBAM certificates cannot be traded, their price will mirror that of ETS allowances as determined by the average closing price on a weekly calendar basis.<sup>12</sup>
- **The EU intends ultimately to expand the CBAM to cover the same goods as the ETS.** In particular, the Commission intends to conduct further analysis of how the CBAM could be applied to refinery products and organic basis chemicals.
- **The CBAM will ultimately replace the existing carbon leakage measures under the ETS.** The existing system for mitigating carbon leakage under the ETS is to counteract the competitive advantage enjoyed by carbon-intensive goods produced outside the EU by issuing free emissions allowances to domestic producers of those goods. The CBAM will allow the EU to phase out this system of free allowances altogether.

### Potential Legal Challenges

The EU insists that the CBAM will be implemented in a manner that is compatible with the rules of the World Trade Organization. Thus far, the WTO itself has remained silent on whether it is likely to regard the CBAM as a violation of its trading rules such as nondiscrimination obligations under the WTO's key GATT principles. However, governments of at least two of the EU's most significant trading partners – China and India – have already indicated that they are contemplating taking steps to contest the CBAM as unduly protectionist, including the possibility of launching a legal challenge in the WTO tribunal. Other countries, including South Korea, Turkey, and Australia, have expressed unease at the burden that the CBAM will impose on their exporters to the EU. According to one study, the top five exporters of CBAM-relevant goods to the EU are the UAE, Ukraine, Belarus, Bosnia and Herzegovnia, and Iran.<sup>13</sup>

### UK CONSULTATION

The UK chose to replace the EU ETS with a separate UK ETS after leaving the EU (after considering moving to a carbon tax instead). As with the EU, the UK's main current measure against carbon leakage has been free allocation of allowances to producers of domestic goods: to that end, the UK plans to focus free allocation on sectors susceptible to carbon leakage.

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The recent UK consultation considers three different types of measure, which are not mutually exclusive:

- **a carbon border adjustment mechanism;**
- **mandatory product standards** (upper limits on embodied emissions for individual products);
- **additional demand-side policies**, such as voluntary product standards, product labelling and procurement guidelines.

Different measures may be applied to different sectors.

The UK's consultation is at an early stage: it seeks views on many questions on which the EU CBAM Regulation has already taken positions – such as which sectors to include; what scope of emissions to include; and how to calculate embedded emissions – as well as points yet to be fleshed out by implementing regulations for the EU CBAM. The earliest a UK CBAM might take effect is 2026.

ENDNOTES

- <sup>1</sup> Regulation (EU) 2023/956 of the European Parliament and of the Council of May 10, 2023 establishing a carbon border adjustment mechanism (the “**CBAM Regulation**”). See full text [here](#).
- <sup>2</sup> Department for Energy Security and Net Zero and His Majesty’s Treasury: Addressing carbon leakage risk to support decarbonisation: A consultation on strategic goals, policy options and implementation considerations, March 30, 2023. See full text [here](#).
- <sup>3</sup> Annex I, CBAM Regulation.
- <sup>4</sup> Article 7, CBAM Regulation. For iron, steel, aluminium, and hydrogen, only direct emissions are to be taken into account. Embedded emissions will be calculated in tonnes of CO2 equivalent per tonne of goods, except for electricity, which will be calculated in tonnes of CO2e per MWh.
- <sup>5</sup> Article 6, CBAM Regulation.
- <sup>6</sup> Full text of draft regulation and annexes and feedback available [here](#). The consultation period runs until July 11, 2023.
- <sup>7</sup> Article 4 and Article 25(1), CBAM Regulation.
- <sup>8</sup> On applications to become a ‘CBAM declarant’, see Articles 5, 14, 16, and 17, CBAM Regulation.
- <sup>9</sup> Article 6(2), CBAM Regulation. The methodology for calculating embedded emissions is set out at Annex IV, CBAM Regulation. Where actual embedded emissions cannot be determined by CBAM declarants, default values set by the Commission may be used instead. For electricity, default values will be used unless the producer is sufficiently integrated into the EU electricity transmission system: the criteria are set out in point 5 of Annex IV
- <sup>10</sup> Article 9 and Article 31, CBAM Regulation.
- <sup>11</sup> Article 20, CBAM Regulation.
- <sup>12</sup> Article 21, CBAM Regulation.
- <sup>13</sup> I. Overland, R. Sabyrbekov, “Know your opponent: Which countries might fight the European carbon border adjustment mechanism?”, Energy Policy, 169 (2022) 113175.

Questions regarding the matters discussed in this publication may be directed to [Max Birke](#), [Craig Jones](#), [Sam Saunders](#) or [Andrew Thomson](#), or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. Additional S&C resources about energy transition matters may be found [here](#).

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