

## Introduction

The European Commission, in July 2021, presented the “Fit for 55” communication<sup>1</sup>, a package of legislative proposals whose main objective is to reduce net greenhouse gas (GHG) emissions in the European Union (EU), to reach climate neutrality by 2050. This package included the revision of the Emissions Trading System (ETS)<sup>2</sup> Directive, and the introduction of the CBAM<sup>3</sup>. Both proposals aim at reducing GHG emissions in identified industrial carbon intensive sectors. In the former case, the scope of the revision was to add new industrial sectors in an already established emissions trading system<sup>4</sup>. In the second case, the EU proposed to introduce a new mechanism to put a levy on GHG emissions embedded in goods imported into the EU. Both new EU laws have been adopted on April 25, 2023, and their entry into force is expected in due course.

## The EU ETS

The EU ETS is the world’s first international emissions trading system. It is based on a mechanism that attributes a cost to the emissions produced by companies in the EU, in selected industrial sectors<sup>5</sup>. The system works following a “Cap and Trade” principle, according to which a ceiling is fixed, establishing the maximum permitted number of annual emissions. Within this limit, companies can buy or sell “allowances” that must correspond to the number of emissions produced in the previous year.

Over the years, the EU ETS has proven to be an effective tool to drive emissions reductions cost-effectively, as installations covered by the ETS reduced emissions by about 35% between 2005 and 2021.

However, the ETS raised the cost of producing certain goods in the EU, which inevitably increases the risk that the production of those goods is moved to countries where there are no charges on the GHG emissions produced.

This risk, if it materializes, in addition to having a negative impact on the EU’s competitiveness, would also result in a rise in total global emissions – thus jeopardizing the primary objective of EU laws and policies on climate.

Against this backdrop, the EU decided to introduce a carbon tariff (i.e., a carbon border adjustment mechanism) on imported goods, that, similarly to the ETS system, corresponds to the emissions caused in the production of those goods outside the EU.

## The CBAM

On April 25, 2023, the EU co-legislators adopted the CBAM Regulation<sup>6</sup>. The CBAM Regulation will impose a charge on the embedded emissions of certain goods imported in the EU, which will be equivalent to the charge imposed on domestic goods under the EU ETS.

The CBAM Regulation applies to goods imported from third countries, except where their production has already been subject to the EU ETS through its application to third countries or to a carbon pricing system linked with the EU ETS. Concretely, importers will have to pay a “carbon tariff”, through the purchase of CBAM certificates that correspond to the emissions produced in a jurisdiction outside the EU. The price of CBAM will be equivalent to an average trading price of EU ETS allowances in the week before the import (expressed in euros per metric ton of CO<sub>2</sub> emitted)<sup>7</sup>.

The CBAM, in a first phase, will cover a limited number of groups of products, namely (1) cement, (2) electricity, (3) fertilizers, (4) iron and steel, (5) aluminum and (6) hydrogen (“CBAM goods”)<sup>8</sup>. By 2030, all product groups currently falling under the ETS will be covered also by the CBAM.

The mechanism will affect direct emissions of greenhouse gases from the time of production of the goods until the import of those goods into the customs territory of the EU. The CBAM will apply also to indirect emissions – i.e., emissions arising from the generation of electricity used to produce the goods to which the regulation applies, but, initially, only for the goods listed in Annex I.

1 COM (2021) 550 final – “Fit for 55”: delivering the EU’s 2030 Climate Target on the way to climate neutrality.

2 COM (2021) 551 final – Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757.

3 COM (2021) 564 final- REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism.

4 With the recent revision of the ETS Directive (adopted on April 25, 2023), the EU introduced, in the ETS system, new sectors, namely shipping emissions, road transport and buildings. The revised directive is expected to be published in the EU Official Journal in Q2 2023 and will enter into force on the twentieth day following that of its publication.

5 Before the adoption of the revision of the ETS Directive, the sectors covered by the ETS were the following – electricity and heat generation, energy-intensive industry sectors, including oil refineries, steel works, and production of iron, aluminum, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals and aviation within the European Economic Area.

6 The REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism (the CBAM Regulation), is expected to be published in the EU Official Journal in Q2 2023 and will enter into force on the twentieth day following that of its publication.

7 Annex IV provides more details on the method of calculation of embedded emissions on imports.

8 Annex I and II of the CBAM Regulation contain the full list of goods that fall within the scope of the law.

The CBAM will be introduced gradually, envisaging only reporting obligations in the first phase. Until the end of 2025, companies will have to report GHG emissions embedded in their imports, without making any financial payments or adjustments. Subsequently, as of January 2026, importers will have to surrender, annually, a number of CBAM certificates corresponding to the GHG emissions embedded in their declared imports.

That said, it should also be noted that changes to this mechanism may apply as a review of the CBAM's functioning will be carried out during its transitional phase and will be concluded before the entry into force of the definitive system<sup>9</sup>.

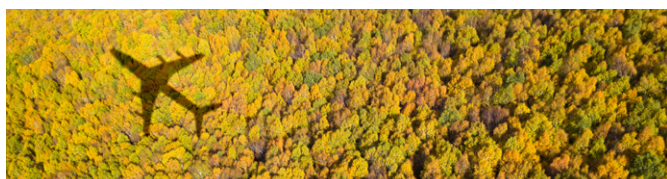
## Impact on Non-EU Companies

The obligations of the system introduced by the CBAM Regulation are imposed on importers and not directly to non-EU companies that export in the EU.

However, even if the obligations to pay the carbon tariffs weigh on the importer, the imposition of the tax will have an impact (inevitably negative) on the purchase price and on demand of goods coming from outside the EU.

Further, to sell CBAM goods to the EU, non-EU companies will have to track the embedded emissions associated with these products (and have these emissions independently verified), as this product-specific information must be provided to the authorized declaration upon importation. This will lead to higher costs to be borne, as well as aggravating the administrative procedures for exports to Europe.

The establishment of the CBAM is expected to intensify bilateral, multilateral, and international cooperation between the EU and third countries. In fact, the regulation encourages the establishment of a forum of countries with carbon pricing instruments in place (e.g., through the establishment of a "Climate Club"), to promote the joint implementation of climate policies. The impact of the formation of these partnerships cannot be estimated at this stage, but it suggests that the EU wants to establish a dialogue with third countries in order to create synergies that reduce global emissions, without hindering international trade.



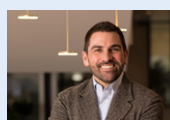
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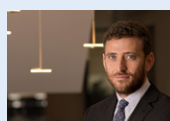
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<sup>9</sup> Also, to be noted that free allowances of the ETS will be phased out in parallel with the phasing-in of CBAM certificates in the period 2026-2034, in order to prevent companies that produce in the EU from having an unfair competitive advantage.